Thirteenth Edition

Accounting

What the Numbers Mean

David H. Marshall, MBA, CPA, CMA

Wayne W. McManus, LLM, JD, MS, MBA, CFA, CPA, CMA, CIA
Professor of Accounting and Law
International College of the Cayman Islands

Daniel F. Viele, MS, CPA, CMA
Professor of Accounting (Retired)
Executive Consultant
Maryville University

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Meet the Authors

David H. Marshall (1933–2018) was a distinguished faculty member at Millikin University, a small, independent university located in Decatur, Illinois. Professor Marshall taught at Millikin for 25 years and was named Professor of Accounting Emeritus upon his retirement in 1992. During his tenure at Millikin, he taught courses in accounting, finance, computer information systems, and business policy, served as Director of Financial Affairs, served twice as Vice President for Business Affairs, and was the Director of Planned Giving in the Development Department. Marshall was honored with a series of universitywide teaching and leadership awards throughout his career, culminating with receiving the prestigious Millikin University Centennial Medallion in 2002. The draft manuscript of this book was written by Professor Marshall in 1986 and used in a one-semester course that was developed for the nonbusiness major. Subsequently supplemented with cases, it was used in the business core accounting principles and managerial accounting courses. Concurrently, a one-credit-hour accounting laboratory taught potential accounting majors the mechanics of the accounting process. Prior to his teaching career, Marshall worked in public accounting and industry and he earned an MBA from Northwestern University. Professor Marshall's interests outside academia included community service, woodturning, sailing, and travel.

Courtesy of David H. Marshall

Wayne W. McManus makes his home in Grand Cayman, Cayman Islands, BWI, where he worked in the private banking sector for several years and is now a semiretired consultant. He maintains an ongoing relationship with the International College of the Cayman Islands as an adjunct Professor of Accounting and Law and serves as the Chair of the College's Board of Trustees. McManus offered the Cayman CPA Review course through the Financial Education Institute Ltd. for a number of years as well as several professional development courses through the Chamber of Commerce. He earned an MS in accounting from Illinois State University, an MBA from the University of Kansas, a law degree from Northern Illinois University, and a master's of law in taxation from the University of Missouri–Kansas City. He served as an independent director and chairman of the audit committee for Endeavour Mining Corp. (EDV on the LSE and TSX exchanges) for 18 years prior to stepping down from the Board in 2020. He is a member of the Cayman Islands Society of Professional Accountants and the local chapter of the CFA Institute. Professor McManus enjoys working as a professional Santa each December, as well as travel, golf, and scuba diving, and is an audio/video enthusiast.

Courtesy of Wayne W. MacManus

Courtesy of Daniel F. Viele

Daniel F. Viele, Professor of Accounting, retired from Maryville University in 2020. During his 7 years at Maryville Professor Viele served as Dean of the School of Adult and Online Education and later as Chief Strategic Information Officer, where he continues to serve Maryville as an executive consultant. Over his 32 years in higher education Professor Viele taught courses in financial, managerial, and cost accounting, as well as accounting information systems. Prior to joining Maryville, Professor Viele's previous teaching experience included 15 years at Webster University and 10 years at Millikin University with Professor Marshall. After Millikin, he spent 8 years in the graphic arts industry, initially with a startup company in St. Louis and then as an industry consultant for a Silicon Valley graphics arts technology company. At Webster Professor Viele pioneered online teaching and learning in the late 1990s where he developed and taught many online courses and over the years led the development of numerous online programs. For his dedication to teaching and the innovative use of technology, Webster awarded him its highest honor—the Kemper Award for Teaching Excellence. Professor Viele holds an MS in accounting from Colorado State University. He has been a member of the American Accounting Association, the AICPA, the Missouri Society of CPAs, and the Institute of Management Accountants. Professor Viele enjoys sports of all kinds, boating, winemaking, and a good book.

Preface

Named after a Chinese word meaning "sparrow," mah-jongg is a centuries-old game of skill. The object of the game is to collect different tiles; players win points by accumulating different combinations of pieces and creating patterns. We've chosen mah-jongg tiles as our cover image for the thirteenth edition of *Accounting: What the Numbers Mean* because the text is designed to show students how to put the pieces together and understand their relationship to one another to see the larger pattern.

Accounting has become known as the language of business. Financial statements result from the accounting process and are used by owners/investors, employees, creditors, and regulators in their planning, controlling, and decision-making activities as they evaluate the achievement of an organization's objectives.

Accounting: What the Numbers Mean takes the user through the basics: what accounting information is, how it is developed, how it is used, and what it means. Financial statements are examined to learn what they do and do not communicate, enhancing the student's decision-making and problem-solving abilities from a user perspective. Achieving expertise in the preparation of financial statements is not an objective of this text. Instead, we have designed these materials to assist those who wish to learn "what the numbers mean" in a clear, concise, and conceptual manner, without focusing on the mechanical aspects of the accounting process.

The user-oriented approach taken by this text will benefit a variety of non-accounting majors, including students focusing on other areas of business or nonbusiness programs such as engineering, behavioral sciences, public administration, or pre-law. Aspiring MBA and other graduate management or administration students who do not have an undergraduate business degree will likewise benefit from a course using this text.

Best wishes for successful use of the information presented here.

Wayne W. McManus

Daniel F. Viele

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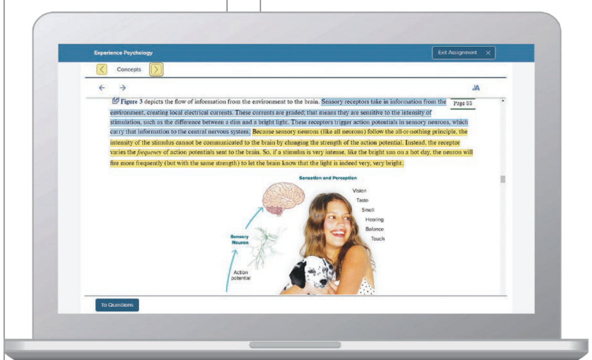

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Enhancements for This Edition

- The Solution's Manual / Instructor's Manual, PowerPoints, Demonstration PowerPoints, and SmartBook 2.0 learning assessment content have been updated based on the revisions made to individual chapters.
- The Test Bank was updated based on individual chapter revisions, with approximately 20 percent updated/revised questions and 10 percent new quantitative multiple-choice questions added. Essay questions have been converted into auto-gradable questions.
- New instructional videos have been added to provide further explanations of chapter content represented by conceptual-oriented learning objectives.

Chapter 1
- Overall chapter content revisions for clarity and general updates.
- Updated references to Campbell's 2020 annual report information.
- Updated discussion of international financial reporting issues with emphasis on progress made in recent years to achieve the maximum possible convergence of IFRS and U.S. GAAP.
- General update of all Exercises.

Chapter 2
- Overall chapter content revisions for clarity and general updates.
- Updated references to Campbell's 2020 annual report information.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M2.1, M2.3, M2-5 (new), M2.6. (new), E2.11, E2.13, E2.15, E2.17, P2.19, P2.21, P2.25, P2.27, and P2.28.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M2.5 and M2.6 have been added.

Chapter 3
- Overall chapter content revisions for clarity and general updates.
- Reintegrated Campbell's 2020 annual report information for the financial and graphical analysis of liquidity and profitability trends.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M3.1, M3.3, M3.5, M3.6 (new), M3.7, M3.8 (new), E3.9, E3.11, E3.13, E3.15, E3.17, E3.19, P3.21, P3.23, and C3.26.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M3.6 and M3.8.

Chapter 4
- Overall chapter content revisions for clarity and general updates.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M4.1 (new), M4.2 (new), M4.5, E4.7, E4.9, E4.11, E4.13, E4.15, E4.17, E4.21, P4.23, P4.24, P4.25, P4.27, P4.29, and C4.31.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M4.1 and M4.2.

Chapter 5
- Overall chapter content revisions for clarity and general updates.
- Updated discussion and analysis of Campbell's 2020 annual report information for the accounting and presentation of current assets, including cash, accounts receivable, and inventories.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M5.1, M5.3, M5.5, M5.7 (new), M5.8 (new), E5.9, E5.11, E5.13, E5.15, E5.17, E5.21, E5.23, E5.25, P5.27, P5.29, P5.31, P5.33, and P5.35.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M5.7 and M5.8.

Chapter 6
- Overall chapter content revisions for clarity and general updates.
- Updated discussion and analysis of Campbell's 2020 annual report information for the accounting and presentation of property, plant, and equipment, and other noncurrent assets.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M6.1 (new), M6.3, M6.4, M6.5, M6.6 (new), E6.7, E6.9, E6.11, E6.15, E6.17, E6.19,

E6.21, P6.23, P6.25, P6.27, P6.29, P6.31, P6.33, and C6.36.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M6.1 and M6.6.

Chapter 7
- Overall chapter content revisions for clarity and general updates.
- Updated discussion and analysis of Campbell's 2020 annual report information for the accounting and presentation of liabilities.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M7.1 (new), M7.3, M7.5 (new), E7.7, E7.9, E7.11, E7.12, E7.13, E7.15, E7.19, E7.21, E7.23, E7.25, P7.29, P7.31, and P7.33.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M7.1 and M7.5.

Chapter 8
- Overall chapter content revisions for clarity and general updates.
- Updated discussion and analysis of Campbell's 2020 annual report information for the accounting and presentation of stockholders' equity.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M8.1 (new), M8.2, M8.4, M8.5 (new), E8.7, E8.9, E8.11, E8.13, E8.15, E8.20, E8.21, E8.23, P8.25, P8.27, P8.29, P8.31, and P8.33.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M8.1 and M8.5.

Chapter 9
- Overall chapter content revisions for clarity and general updates.
- Updated discussion and analysis of Campbell's 2020 annual report information for the presentation and disclosure of income statement and statement of cash flows data.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M9.1 (new), M9.2, M9.3, M9.4, M9.5 (new), M9.6, E9.7, E9.9, E9.10, E9.11, E9.14, E9.15, E9.17, E9.20, P9.21, P9.23, P9.27, and C9.35.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M9.1 and M9.5.

Chapter 10
- Overall chapter content revisions for clarity and general updates.
- Updated discussion and analysis of Campbell's 2020 annual report information for the Notes to the Financial Statements section of the chapter.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M10.1, M10.2, E10.3, E10.7, E10.9, P10.11, P10.12, and C10.14.

Chapter 11
- Overall chapter content revisions for clarity and general updates.
- Updated discussion of Campbell's 2020 annual report information for the performance of financial ratio analysis.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M11.1, M11.2 (new), M11.3, M11.4 (new), M11.5, M11.6 (new), M11.7, M11.8 (new), P11.13, P11.14, P11.16, P11.18, and C11.20.
- Addition of guided example video demonstrations for new end of chapter Mini-Exercises M11.2, M11.4, M11.6 and M11.8.

Chapter 12
- Overall chapter content revisions for clarity and general updates; addition of specific rewrites or enhancements to add clarity or visualization of concepts to the following content items: the relevant range assumption, operating income and the transition to cost behavior concepts, the high-low method and Exhibit 12-5, CVP and decision making, CM Ratio in Action—Example 5, and CM Ratio in Action—Example 6.
- Chapter Study Suggestion and Business in Practice boxes updated or replaced. All FYI boxes have been converted to Business in Practice boxes.
- General update of all Mini-Exercises, Exercises, Problems, and Cases; items specifically refreshed: M12.1, M12.2, E12.9, E12.11, E12.13, E12.15, E12.17, P12.19, P12.21, P12.23, P12.25, P12.27, P12.29, and P12.35.

Chapter 13

- Overall chapter content revisions for clarity and general updates; addition of specific rewrites or enhancements for clarity or visualization of concepts to the following content items: chapter introduction, manufacturing inputs, Campbell Soup Company cost of goods sold performance, and implementing Activity-Based Costing.
- Chapter Study Suggestion and Business in Practice boxes updates or replacements; conversion of all FYI boxes to Business in Practice boxes.
- General update of all Mini-Exercises, Exercises, Problems, and Cases. Specific items that have been refreshed include: M13.1, M13.3, M13.5, E13.9, E13.11, E13.15, E13.17, E13.19, E13.21, P13.23, P13.25, P13.27, P13.29, C13.31, and C13.34.

Chapter 14

- Overall chapter content revisions for clarity and general updates; addition of specific rewrites or enhancements for clarity or visualization of concepts to the following content items: budget assumptions, and timing analysis of cash receipts and cash disbursements.
- Chapter Study Suggestion and Business in Practice boxes updated or replaced; conversion of all FYI boxes to Business in Practice boxes.
- General update of all Mini-Exercises, Exercises, Problems, and Cases. Specific items that have been refreshed include: M14.1, M14.7, E14.9, E14.11, E14.13, E14.15, E14.17, P14.19, P14.21, P14.22, P14.23, P14.25 and C14.28.

Chapter 15

- Overall chapter content revisions for clarity and general updates. Specific rewrites or enhancements to add clarity or visualization of concepts have been added for the following content items: budget variances and assessing responsibility, direct labor rate variance and direct labor efficiency variance explanation, and discussion of segment reporting.
- Chapter Study Suggestion and Business in Practice boxes updated or replaced. All FYI boxes have been converted to Business in Practice boxes.
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Chapter 16

- Overall chapter content revisions for clarity and general updates. Specific rewrites or enhancements to add clarity or visualization of concepts have been added for the following content items: analysis of Exhibit 16-2, relevant costs for discontinuing a segment of the organization, antitrust law and price discrimination, and availability of capital budgeting resources.
- Chapter Study Suggestion and Business in Practice boxes updated or replaced. All FYI boxes have been converted to Business in Practice boxes.
- General update of all Mini-Exercises, Exercises, Problems, and Cases. Specific items that have been refreshed include: M16.1, M16.2, M16.3, M16.5, E16.11, E16.13, E16.15, E16.17, E16.19, E16.21, E16.23, E16.25, E16.27, P16.29, P16.31, P16.33, P16.35, P16.37, and C16.41.

Epilogue:

- Overall content revisions for clarity and general updates. Specific rewrites or enhancements to add clarity or visualization of concepts have been added for the following content items: welcome section and scandals discussion, ethics compliance and corporate progress, IFRS adoption and reporting in the United States, data warehousing, data mining, big data, predictive analytics, prescriptive analytics, artificial intelligence, and cyber security.
- New infographic added for IFRS adoption status in the United State.
- Updated or added FYI box information for the following items: worst corporate scandals, CPA Vision Project and Horizons 2025 Report, information resources for big data, artificial intelligence, digital humans, and digital transformation.

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We Are Grateful . . . Although the approach to the material and the scope of coverage in this text are the results of our own conclusions, truly new ideas are rare. The authors whose textbooks we have used in the past have influenced many of our ideas for particular accounting and financial management explanations. Likewise, students and colleagues through the years have helped us clarify illustrations and teaching techniques. Many of the users of the first 12 editions—both teachers and students—have offered comments and constructive criticisms that have been encouraging and helpful. All this input is greatly appreciated.

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Wayne W. McManus   *Daniel F. Viele*

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Accounting

1 Accounting—Present and Past

The worldwide financial and credit crisis that came to a head in the fall of 2008 was precipitated by many factors. Not the least of these factors were greed, inadequate market regulatory supervision, and an excess of “financial engineering” involved in the creation of financial instruments that almost defied understanding even by sophisticated investors. This crisis was preceded in the first decade of the century by the bankruptcy filings of two large, publicly owned corporations, which resulted in billions of dollars of losses by thousands of stockholders. In 2001, it had been Enron Corporation, and a few months later, WorldCom Inc. In each case, a number of factors caused the precipitous fall in the value of the firms’ stock. The most significant factor was probably the loss of investor confidence in each company’s financial reports and other disclosures reported to stockholders and regulatory bodies, including the Securities and Exchange Commission (SEC).

The Enron and WorldCom debacles, and other widely publicized breakdowns of corporate financial reporting, resulted in close scrutiny of such reporting by the accounting profession itself and also by the U.S. Congress and other governing bodies. The accounting practices that were criticized generally involved complex transactions.

Also contributing to the issue were aggressive attempts by some executives to avoid the spirit of sound accounting, even though many of the financial reporting practices in question were not specifically forbidden by existing accounting pronouncements at that time. To be sure, the financial reporting requirements faced by companies whose securities are publicly traded have since become more strenuously scrutinized under the Sarbanes–Oxley Act of 2002 (SOX) and the watchful eye of the Public Company Accounting Oversight Board (PCAOB), which is the regulatory body created under SOX to oversee the activities of the auditing profession and further protect the public interest. These enhanced regulatory efforts have helped to increase the transparency of the financial reporting process and the understandability of financial statements. Although the financial crisis that disrupted the financial world in 2008 was not directly blamed on financial accounting or auditing weaknesses, some accounting and financial reporting practices that existed at that time were severely criticized. This book briefly addresses some of the more troublesome technical issues still faced by the accounting profession today, but the elaborate attempts to embellish the financial image of those companies in question certainly went beyond the fundamentals described in the following pages.

The objective of this text is to present enough of the fundamentals of accounting to permit the nonaccountant to understand the financial statements of an organization operating in our society and to understand how financial information can be used in the management planning, control, and decision-making processes. Although usually expressed in the context of profit-seeking business enterprises, most of the material presented here is equally applicable to not-for-profit social service and governmental organizations.

Accounting is sometimes called the *language of business,* and it is appropriate for people who are involved in the economic activities of our society—and that is just about everyone—to know at least enough of this language to be able to make decisions and informed judgments about those economic activities.

LEARNING OBJECTIVES

After studying this chapter, you should understand and be able to

LO 1-1 Explain the definition of *accounting.*

LO 1-2 Identify who the users of accounting information are and explain why they find accounting information useful.

LO 1-3 Identify the variety of professional services that accountants provide.

LO 1-4 Summarize the development of accounting from a broad historical perspective.

LO 1-5 Explain the role that the FASB plays in the development of financial accounting standards.

LO 1-6 Generalize about how financial reporting standards evolve.

LO 1-7 Identify the key elements of ethical behavior for a professional accountant.

LO 1-8 Summarize the reasons for the FASB's Conceptual Framework project.

LO 1-9 Summarize the objective of general-purpose financial reporting.

LO 1-10 Describe the plan of the book.

What Is Accounting?

LO 1-1
Explain the definition of *accounting.*

In a broad sense, **accounting** is the process of identifying, measuring, and communicating economic information about an organization for the purpose of making decisions and informed judgments. (Accountants frequently use the term **entity** instead of *organization* because it is more inclusive.)

This definition of accounting can be expressed schematically as follows:

Accounting is the process of

$$\left.\begin{matrix}\text{Identifying}\\ \text{Measuring}\\ \text{Communicating}\end{matrix}\right\} \begin{matrix}\text{Economic information}\\ \text{about an entity}\end{matrix} \rightarrow \begin{matrix}\text{For decisions and}\\ \text{informed judgments}\end{matrix}$$

Exhibit 1-1
Users and Uses of Accounting Information

User	Decision/Informed Judgment Made
Management	When performing its functions of planning, directing, and controlling, management makes many decisions and informed judgments. For example, when considering the expansion of a product line, planning involves identifying and measuring costs and benefits; directing involves communicating the strategies selected; and controlling involves identifying, measuring, and communicating the results of the product line expansion during and after its implementation.
Investors/shareholders	When considering whether to invest in the common stock of a company, **investors** use accounting information to help assess the amounts, timing, and uncertainty of future cash returns on their investment.
Creditors/suppliers	When determining how much merchandise to ship to a customer before receiving payment, **creditors** assess the probability of collection and the risks of late (or non-) payment. Banks also become creditors when they make loans and thus have similar needs for accounting information.
Employees	When planning for retirement, employees assess the company's ability to offer long-term job prospects and an attractive retirement benefits package.
SEC (Securities and Exchange Commission)	When reviewing for compliance with SEC regulations, analysts determine whether financial statements issued to investors fully disclose all required information.

LO 1-2
Identify who the users of accounting information are and explain why they find accounting information useful.

Who makes these decisions and informed judgments? Users of accounting information include the management of the entity or organization; the owners of the organization (who are frequently not involved in the management process); potential investors in and creditors of the organization; employees; and various federal, state, and local governmental agencies that are concerned with regulatory and tax matters. Exhibit 1-1 describes some of the users and uses of accounting information. Pause, and try to think of at least one other decision or informed judgment that each of these users might make from the economic information that could be communicated about an entity.

Accounting information is required for just about every kind of organization. When accounting is mentioned, most people initially think of the information needs and reporting requirements of business firms, but not-for-profit social service organizations, governmental units, educational institutions, social clubs, political committees, and other groups all require accounting for their economic activities as well.

Accounting is frequently perceived as something that others who are good with numbers do, rather than as the process of providing information that supports decisions and informed judgments. Relatively few people become accountants, but almost all people use accounting information. The principal objective of this text is to help you become an informed user of accounting information, rather than to prepare you to become an accountant. However, the essence of this user orientation provides a solid foundation for students who choose to seek a career in accounting.

If you haven't already experienced the lack of understanding or confusion that results from looking at a set of financial statements, you have been spared one of life's frustrations. Certainly during your formal business education and early during your employment experience, you will be presented with financial data. Being an informed user means knowing how to use those data as information.

The following sections introduce the major areas of practice within the accounting discipline and will help you understand the types of work done by professional accountants within each of these broad categories. In a similar way, the accompanying Business in Practice discussion highlights career opportunities in accounting.

1. What does it mean to state that the accounting process should support decisions and informed judgments?

What Does It Mean?
Answer on page 27

Business in Practice

Career Opportunities in Accounting

Because accounting is a profession, most entry-level positions require at least a bachelor's degree with a major in accounting. Individuals are encouraged to achieve Certified Public Accountant (CPA) licensure as quickly as feasible and/or to attend graduate school to pursue an area of specialization. Persons who work hard and smart can expect to attain high professional levels in their careers. The major employers of accountants include public accounting firms, industrial firms, government, and not-for-profit organizations.

Public Accounting

The work done by public accountants varies significantly depending on whether they are employed by a local, regional, or international CPA firm. Small local firms concentrate on the bookkeeping, accounting, tax return, and financial planning needs of individuals and small businesses. These firms need generalists who can adequately serve in a variety of capacities. The somewhat larger, regional firms offer a broad range of professional services but concentrate on the performance of audits (frequently referred to as *attestation* or *compliance services*), corporate tax returns, and management advisory services. They often hire experienced financial and industry specialists to serve particular client needs, in addition to recruiting well-qualified recent graduates.

The large, international CPA firms also perform auditing, tax, and consulting services. Their principal clients are large domestic and international corporations. The "Big 4" CPA firms are Deloitte Touche Tohmatsu (Deloitte), PricewaterhouseCoopers (known as PwC), EY (formerly Ernst & Young), and KPMG International (KPMG). These firms dominate the market in terms of total revenues; number of corporate audit clients; and the number of offices, partners, and staff members. The Big 4 international firms generally recruit outstanding graduates and highly experienced CPAs and encourage the development of specialized skills by their personnel. (*Visit any of the Big 4 websites for detailed information regarding career opportunities in public accounting:* deloitte.com, pwc.com , ey.com, or kpmg.com.)

Industrial Accounting

More accountants are employed in industry than in public accounting because of the vast number of manufacturing, merchandising, and service firms of all sizes. In addition to using the services of public accounting firms, these firms employ cost and management accountants, as well as financial accountants. Many accountants in industry start working in this environment right out of school; others get their start in public accounting as auditors but move to industry after getting at least a couple of years of experience.

Government and Not-for-Profit Accounting

Opportunities for accounting professionals in the governmental and not-for-profit sectors of the economy are constantly increasing. In the United States, literally thousands of state and local government reporting entities touch the lives of every citizen. Likewise, accounting specialists are employed by colleges and universities, hospitals, and voluntary health and welfare organizations such as the Salvation Army, American Red Cross, United Way, and Goodwill.

Financial Accounting

LO 1-3
Identify the variety of professional services that accountants provide.

Financial accounting generally refers to the process that results in the preparation and reporting of financial statements for an entity. As will be explained in more detail, financial statements present the financial position of an entity at a point in time, the results of the entity's operations for some period of time, the **cash flow** activities for the same period, and other information (the notes to the financial statements or financial review) about the entity's financial resources, obligations, owners'/stockholders' interests, and operations.

Financial accounting is primarily oriented toward the external user. The financial statements are directed to individuals who are not in a position to be aware of the day-to-day financial and operating activities of the entity. Financial accounting is also primarily concerned with the historical results of an entity's performance. Financial statements reflect what has happened in the past. Although readers may want to project past activities and their results into future performance, financial statements are not a crystal ball. Many corporate annual reports refer to the historical nature of financial accounting information to emphasize that users must make their own judgments about a firm's future prospects.

Bookkeeping procedures are used to accumulate the financial results of many of an entity's activities, and these procedures are part of the financial accounting and process. Bookkeeping procedures have been thoroughly systematized using manual, mechanical, and computer techniques. Although these procedures support the financial accounting and reporting process, they are only a part of the process.

Financial accounting is done by accounting professionals who have generally earned a bachelor's degree with a major in accounting. The financial accountant is employed by an entity to use her or his expertise, analytical skills, and judgment in the many activities that are necessary for the preparation of financial statements. The title **controller** is used to designate the chief accounting officer of a corporation. The controller is usually responsible for both the financial and managerial accounting functions of the organization (as discussed later). Sometimes the title *comptroller* (the Old English spelling) is used for this position.

An individual earns the **Certified Public Accountant (CPA)** professional designation by fulfilling certain education and experience requirements and passing a comprehensive four-part examination. A uniform CPA exam is given nationally, although it is administered by individual states.[1] Some states require that candidates have accounting work experience before sitting for the exam. Each of the 55 U.S. jurisdictions, including all 50 states, have now enacted legislation increasing the educational requirements for CPA candidates from 120 semester hours of college study, or a bachelor's degree, to a minimum of 150 semester hours of college study to be granted licensure as a CPA. Thirty-two of these states allow candidates to sit for the CPA exam with 120 hours, but require 150 hours for certification.[2] The American Institute of Certified Public Accountants (AICPA), the national professional organization of CPAs, has also endorsed this movement by requiring that an individual CPA wanting to become a member must have met the 150-hour requirement. This increase in the educational requirements for becoming a CPA and for joining the AICPA reflects the

[1] Since 2004, CPA candidates have been allowed to schedule their own exam dates; they may sit for one part at a time because the examination is now computer-based. The former "pencil and paper" CPA exam has become a relic of the past.

[2] See becker.com/cpa-review/requirements to learn about the requirements for your state.

increasing demands placed on accounting professionals to be both broadly educated and technically competent. Practicing CPAs work in all types of organizations, but as explained later, a CPA who expresses an auditor's opinion about an entity's financial statements must be licensed by the jurisdiction/state in which she or he performs the auditing service.

Managerial Accounting/Cost Accounting

Managerial accounting is concerned with the use of economic and financial information to plan and control many activities of the entity and to support the management decision-making process. **Cost accounting** is a subset of managerial accounting that relates to the determination and accumulation of product, process, or service costs. Managerial accounting and cost accounting have primarily an internal orientation, in contrast to the primarily external orientation of financial accounting. Many of the same data used in or generated by the financial accounting process are used in managerial and cost accounting, but the data are more likely to be used in a future-oriented way, such as in the preparation of budgets. A detailed discussion of the similarities and differences between financial and managerial accounting is provided in Chapter 12 and highlighted in Exhibit 12-1.

Managerial accountants and cost accountants are professionals who have usually earned a bachelor's degree with a major in accounting. Their work frequently involves close coordination with the production, marketing, and finance functions of the entity. The **Certified Management Accountant (CMA)** designation can be earned by a management accountant or cost accountant by passing a broad two-part examination. Each part of the CMA examination is given in a computer-based format and consists of three hours of descriptive (multiple-choice) questions and two 30-minute essay questions.

Auditing—Public Accounting

Many entities have their financial statements reviewed or examined by an independent third party. In most cases, an audit (examination) is required by securities laws if the stock or bonds of a company are owned and publicly traded by investors. **Public accounting** firms and individual CPAs provide this **auditing** service, which constitutes an important part of the accounting profession.

The result of an audit is the **independent auditor's report**. The report usually has four relatively brief paragraphs. The first paragraph identifies the financial statements that were audited, explains that the statements are the responsibility of the company's management, and states that the auditor's responsibility is to express an opinion about the financial statements. The second paragraph explains that the audit was conducted "in accordance with the standards of the Public Company Accounting Oversight Board (United States)" and describes briefly what those standards require and what work is involved in performing an audit. (In effect, they require the application of **generally accepted auditing standards,** *or* **GAAS**.) The third paragraph contains the auditor's opinion, which is usually that the named statements "present fairly, in all material respects" the financial position of the entity and the results of its operations and cash flows for the identified periods "in conformity with U.S. generally accepted accounting principles." This is an unqualified, or "clean," opinion. Occasionally the opinion will be qualified with respect to fair presentation, departure from **generally accepted accounting principles (GAAP)**, or the auditor's inability to perform certain auditing procedures. Similarly, an explanatory paragraph may be added to an unqualified opinion regarding the firm's ability to continue as a going concern (that is, as a viable economic entity) when substantial doubt exists. An unqualified opinion is not a clean bill of health about either the current financial condition or the future prospects of the entity. Readers must reach their own judgments about these and other matters after studying the **annual report**, which includes the financial statements and the notes to the financial statements, as well as management's extensive discussion and analysis. A final paragraph makes reference to the auditors' opinion about the effectiveness of the company's internal control over financial reporting. The entire auditors' report is further discussed in Chapter 10.

Auditors who work in public accounting are professional accountants who usually have earned at least a bachelor's degree with a major in accounting. The auditor may work for a public accounting firm (a few firms have several thousand partners and professional staff) or as an individual practitioner. Most auditors seek and earn the CPA designation; the firm partner or individual practitioner who signs the audit opinion must be a licensed CPA in the state in which she or he practices. To be licensed, the CPA must satisfy the character, education, examination, and experience requirements of the state or other jurisdiction.

Campbell's

To see an example of the independent auditors' report, refer to pages 87–88 in the 2020 annual report of Campbell Soup Company, selected portions of which are reproduced in the appendix.

What Does It Mean?

Answers on page 27

2. What does it mean to work in public accounting?
3. What does it mean to be a CPA?

Internal Auditing

Organizations with many plant locations or activities involving many financial transactions employ professional accountants to do **internal auditing**. In many cases, the internal auditor performs functions much like those of the external auditor/public accountant, but perhaps on a smaller scale. For example, internal auditors may be responsible for reviewing the financial statements of a single plant or for analyzing the operating efficiency of an entity's activities. The qualifications of an internal auditor are similar to those of any other professional accountant. In addition to having the CPA and the CMA designation, the internal auditor may have also passed the examination to become a Certified Internal Auditor (CIA).

Governmental and Not-for-Profit Accounting

Governmental units at the municipal, state, and federal levels and not-for-profit entities, such as colleges and universities, hospitals, and voluntary health and welfare organizations, require the same accounting functions to be performed as do other accounting entities. Religious organizations, labor unions, trade associations, performing arts organizations, political parties, libraries, museums, country clubs, and many other not-for-profit organizations employ accountants with similar educational qualifications as those employed in business and public accounting.

Income Tax Accounting

The growing complexity of federal, state, municipal, and foreign income tax laws has led to a demand for professional accountants who are specialists in various aspects of taxation. Tax practitioners often develop specialties in the taxation of individuals, partnerships, corporations, trusts and estates, or in international tax law issues. These accountants work for corporations, public accounting firms, governmental units, and other entities. Many tax accountants have bachelor's degrees and are CPAs; some have a master's degree in accounting or taxation or are attorneys as well.

How Has Accounting Developed?

LO 1-4
Summarize the development of accounting from a broad historical perspective.

Accounting has developed over time in response to the needs of users of financial statements for financial information to support decisions and informed judgments such as those mentioned in Exhibit 1-1 and others that you were challenged to identify. Even though an aura of exactness is conveyed by the numbers in financial statements, a great deal of judgment and approximation is involved in determining the numbers to be reported. Although broad, generally accepted principles of accounting exist, different accountants may reach different but often equally legitimate conclusions about how to account for a particular transaction or event. A brief review of the history of the development of accounting principles may make this often confusing state of affairs a little easier to understand.

Early History

It is not surprising that evidence of record keeping for economic events has been found in the earliest civilizations. Dating back to the clay tablets used by Mesopotamians in about 3000 B.C. to record tax receipts, accounting has responded to the information needs of users. In 1494, Luca Pacioli, a Franciscan monk and mathematics professor, published the first known text to describe a comprehensive double-entry bookkeeping system. Modern bookkeeping systems (as discussed in Chapter 4) have evolved directly from Pacioli's "method of Venice" system, which was developed in response to the needs of the Italian mercantile trading practices in that period.

The Industrial Revolution generated the need for large amounts of capital to finance the enterprises that supplanted individual craftsmen. This need resulted in the corporate form of organization marked by absentee owners, or investors, who entrusted their money to managers. It followed that investors required reports from the corporate managers showing the entity's financial position and results of operations. In mid-19th-century England, the independent (external) audit function added credence to financial reports. As British capital was invested in a growing U.S. economy in the late 19th century, British-chartered accountants and accounting methods came to the United States. However, no group was legally authorized to establish financial reporting standards. This led to alternative methods of reporting financial condition and results of operations, which resulted in confusion and, in some cases, outright fraud.

The Accounting Profession in the United States

Accounting professionals in this country organized themselves in the early 1900s and worked hard to establish certification laws, standardized audit procedures, and other attributes of a profession. However, not until 1932–1934 did the American Institute of Accountants (predecessor of today's American Institute of Certified Public

Accountants—AICPA) and the New York Stock Exchange agree on five broad principles of accounting. This was the first formal accounting standard-setting activity. The accounting, financial reporting, and auditing weaknesses related to the 1929 stock market crash gave impetus to this effort.

The Securities Act of 1933 and the Securities Exchange Act of 1934 apply to securities offered for sale in interstate commerce. These laws had a significant effect on the standard-setting process because they gave the **Securities and Exchange Commission (SEC)** the authority to establish accounting principles to be followed by companies whose securities had to be registered with the SEC. The SEC still has this authority, but the standard-setting process has been delegated to other organizations over the years. Between 1939 and 1959, the Committee on Accounting Procedure of the American Institute of Accountants issued 51 *Accounting Research Bulletins* that dealt with accounting principles. This work was done without a common conceptual framework for financial reporting. Each bulletin dealt with a specific issue in a relatively narrow context, and alternative methods of reporting the results of similar transactions remained.

In 1959, the Accounting Principles Board (APB) replaced the Committee on Accounting Procedure as the standard-setting body. The APB was an arm of the AICPA, and although it was given resources and directed to engage in more research than its predecessor, its early efforts intensified the controversies that existed. The APB issued 39 *Opinions* on serious accounting issues, but it failed to develop a conceptual underpinning for accounting and financial reporting.

Financial Accounting Standard Setting at the Present Time

LO 1-5
Explain the role that the FASB plays in the development of financial accounting standards.

In 1973, as a result of congressional and other criticism of the accounting standard-setting process being performed by an arm of the AICPA, the **Financial Accounting Foundation (FAF)** was created as a more independent entity. The foundation established the **Financial Accounting Standards Board (FASB)** as the authoritative standard-setting body within the accounting profession. The FASB embarked on a project called the Conceptual Framework of Financial Accounting and Reporting and had issued eight *Statements of Financial Accounting Concepts* by February 2021.

Concurrently with its Conceptual Framework project, the FASB issued 168 ***Statements of Financial Accounting Standards*** **(SFAS)** that established standards of accounting and reporting for particular issues, much as its predecessors did. Effective in July 2009, however, all such FASB standards were superseded by the ***FASB Accounting Standards Codification*** **(FASB Codification)**. Essentially, the FASB Codification reorganized divergent sources of U.S. GAAP in a more accessible and researchable format. The FASB Codification now represents a single source of U.S. GAAP. Changes to the Codification are communicated through an ***Accounting Standards Update*** **(Update** *or* **ASU)**, regardless of the form in which such guidance may have been issued prior to the release of the FASB Codification. Although such Updates do in fact amend the FASB Codification, the FASB does not consider ASUs as authoritative in their own right. A total of 192 ASUs had been issued by February 2021.

Alternative ways of accounting for and reporting the effects of similar transactions still exist. In many aspects of financial reporting, the accountant still must use judgment in selecting between equally acceptable alternatives. To make sense of financial statements, one must understand the impact of the accounting methods used by a firm, relative to alternative methods that were not selected. Subsequent chapters describe many of these alternatives and the impact that various accounting choices have on financial statements. As examples, Chapter 5 discusses the effects of the first-in, first-out inventory cost flow assumption in comparison to the last-in, first-out and the weighted-average assumptions; similarly, Chapter 6 discusses the difference between the straight-line and accelerated methods of depreciating long-lived assets. Although such terminology may not be meaningful to you at this time, you should understand that the FASB has sanctioned each of these alternative methods of accounting for inventory and depreciation, and that the methods selected can significantly affect a firm's reported profits.

The FASB does not set standards in a vacuum. An open, due process procedure is followed. The FASB invites input from any individual or organization who cares to provide ideas and viewpoints about the particular standard under consideration. Among the many professional accounting and financial organizations that regularly present suggestions to the FASB, in addition to the AICPA and the SEC, are the **International Accounting Standards Board (IASB)**, the American Accounting Association, the Institute of Management Accountants, Financial Executives International, and the Chartered Financial Analysts (CFA) Institute.

The accounting and auditing standard-setting processes were heavily criticized as a result of the Enron and WorldCom collapses and the accounting and reporting problems of other companies that came to light in 2001 and early 2002. In July 2002, President George W. Bush signed into law the most significant legislation affecting the accounting profession since 1933: the Sarbanes–Oxley Act (SOX) of 2002. Essentially, the act created a five-member **Public Company Accounting Oversight Board (PCAOB)**, which has the authority to set and enforce auditing, attestation, quality control, and ethics (including independence) standards for public companies. It is also empowered to inspect the auditing operations of public accounting firms that audit public companies and impose disciplinary sanctions for violations of the Board's rules, securities laws, and professional auditing standards. The impact of SOX on financial reporting has been far reaching and will be explored in some detail in Chapter 10, which addresses corporate governance and disclosure issues.

LO 1-6
Generalize about how financial reporting standards evolve.

The point of this discussion is to emphasize that financial accounting and reporting practices are not based on a set of inflexible rules to be mastered and blindly followed. The reality is that financial reporting practices have evolved over time in response to the changing needs of society, and they are still evolving. In recent years, financial instruments and business transactions have become increasingly complex and are now being used with greater frequency by firms of all sizes. The FASB has thus been hard pressed to develop appropriate standards to adequately address emerging accounting issues in a timely manner. Moreover, many recent ASUs appear to be more like rules than the judgmental application of fair guidelines. Don't worry about any critical reviews you may read concerning new FASB Codification updates; instead, keep your eye on the big picture. Your objective is to learn enough about the fundamentals of financial accounting and reporting practices to be neither awed nor confounded by the overall presentation of financial data.

4. What does it mean to state that generally accepted accounting principles are not a set of rules to be blindly followed?

5. What does it mean when the Financial Accounting Standards Board issues a new *Accounting Standards Update*?

What Does It Mean?
Answers on page 27

Standards for Other Types of Accounting

Because managerial/cost accounting is oriented primarily to internal use, it is presumed that internal users will know about the accounting practices being followed by their firms. As a result, the accounting profession has not regarded the development of internal reporting standards for use by management as an important issue. Instead, individual companies are generally allowed to self-regulate with respect to internal reporting matters. One significant exception is accounting for the cost of work done under government contracts. Over the years, various governmental agencies have issued directives prescribing the procedures to be followed by government contractors. During the 1970–1980 period, the **Cost Accounting Standards Board (CASB)** operated as a governmental body to establish standards applicable to government contracts. Congress abolished the CASB in 1981, although its standards remained in effect. In 1988, Congress reestablished the CASB as an independent body within the Office of Federal Procurement Policy. The CASB now has authority to establish cost-accounting standards for government contracts in excess of $750,000, provided that the contractor or subcontractor is performing a total of $7.5 million or more in all such contracts. Since 1995, CASB standards also have applied to colleges and universities that receive major federal research funds.

In the auditing/public accounting area, auditing, attestation, and quality control standards are established by the Auditing Standards Board, a technical committee of the AICPA, unless superseded or amended by the PCAOB. The SEC has had input into this process, and over the years a number of auditing standards and procedures have been issued. One of the most important of these standards requires the auditor to be *independent* of the client whose financial statements are being audited. Yet the auditor's judgment is still very important in the auditing process. Because of this, critics of the accounting profession often raise questions concerning the independence of CPA firms in the auditing process (see Business in Practice—Auditor Independence). It is worth repeating here that an unqualified auditor's opinion does not constitute a clean bill of health about either the current financial condition of or the future prospects for the entity. It is up to the readers of the financial statements to reach their own judgments about these and other matters after studying the firm's annual report, which includes the financial statements and notes to the financial statements.

In 1984, the **Governmental Accounting Standards Board (GASB)** was established to develop guidelines for financial accounting and reporting by state and local governmental units. The GASB operates under the auspices of the Financial Accounting Foundation, which is also the parent organization of the FASB. The GASB is attempting to unify practices of the nation's many state and municipal entities, thus providing investors and taxpayers with a better means of comparing financial data of the issuers of state and municipal securities. In the absence of a GASB standard for a particular activity or transaction occurring in both the public and private sectors, governmental entities will continue to use FASB standards for guidance. The GASB had issued 97 standards and 6 concepts statements by February 2021.

The U.S. Internal Revenue Code and related regulations and the various state and local tax laws specify the rules to be followed in determining an entity's income tax liability. Although quite specific and complicated, the code and regulations provide rules of law to be followed. In income tax matters, accountants use their judgment and expertise to design transactions so that the entity's overall income tax liability is minimized. In addition, accountants prepare or help prepare tax returns and may represent clients whose returns are being reviewed or challenged by taxing authorities.

Business in **Practice**

Auditor Independence

Certified public accountants have traditionally provided auditing, tax, and consulting services designed to meet a broad range of client needs. In recent years, the consultancy area of practice has expanded considerably, especially among the Big 4 international CPA firms. Consulting services commonly offered include financial advisory services, assurance (risk management) services, and information systems design and installation services. Until recent years, it was not unusual for a CPA firm to provide such services to its audit clients.

In the opinion of some observers, including the SEC, having the auditing firm involved in the development of information and accounting systems raises the possibility and appearance of a conflict of interest. Such a conflict might arise if the auditors are reluctant to challenge the results of a system from which the amounts shown on an audit client's financial statements were derived. The appearance of independence could be further affected by the fact that consulting fees frequently exceed the auditing fees generated from many corporate clients.

For several years prior to the Enron case, the SEC and the AICPA discussed the impact of auditors' consulting practices on auditor independence. To help achieve independence in fact and in appearance, several auditing firms split off their consulting practices, thus making them separate entities. However, when it was learned that Arthur Andersen had earned considerably more in consulting fees from Enron than it had earned in auditing fees, and that this situation prevailed for many auditing firms, there was strong pressure to require all auditing firms to divest their consulting practices. As discussed in Chapter 10, SOX now prohibits auditors from performing a variety of nonaudit services for financial statement audit clients. Clearly, the issue of auditor independence continues to have a "hot button" status, and it is likely to remain under close scrutiny for the foreseeable future.

International Accounting Standards

Accounting standards in individual countries have evolved in response to the unique user needs and cultural attributes of each country. Thus, despite the development of a global marketplace, accounting standards in one country may differ significantly from those in another country. In 1973, the International Accounting Standards Committee (IASC) was formed by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States to create and promote worldwide acceptance and observation of accounting and financial reporting standards. In 2001, the International Accounting Standards Board (IASB) was formed in a restructuring effort and has since assumed all responsibilities previously carried out by the IASC, which was disbanded at that time. The IFRS Foundation, based in London, is the legal entity under which the IASB operates as an independent, not-for-profit private sector organization.

The goal of the IASB is to develop a single set of high-quality, understandable, enforceable, and globally accepted financial reporting standards based on clearly articulated principles. The IASB and its predecessor organization had issued 41 International Accounting Standards (IAS) and 17 **International Financial Reporting Standards (IFRS)** by February 2021, with much of this progress coming in recent years. As a result, all major nations except the United States have now established timelines to substantially converge with or fully adopt IFRS standards in the near future.

The IASB and the FASB have been working together since 2002 to achieve convergence of IFRS and U.S. GAAP. The principal difference between IFRS and U.S.

GAAP is that U.S. financial reporting standards have been increasingly based on detailed rules, whereas IFRS standards require companies to follow broad principles, which can result in "situational" accounting that can lead to financial reporting differences between companies having similar transactions. With this in mind, the boards agreed on a Memorandum of Understanding in 2006 (updated in 2008 and again in 2010) that identified several short-term and longer-term convergence projects that would bring the most significant improvements to IFRS and U.S. GAAP. Through these ongoing projects—some covering major components of the financial statements, such as leases, impairment of financial instruments, and insurance contracts—the boards intend to improve financial reporting to investors while also aligning U.S. and international standards.

In November 2008, the SEC issued a "Roadmap" discussion paper for a possible path to the adoption of IFRS standards in the United States. In May 2011, the SEC released a more detailed proposal for the FASB to change U.S. GAAP over a defined period of perhaps five to seven years by endorsing, and thereby incorporating, individual IFRS standards into U.S. GAAP. Under this proposal, the FASB would have continued as the U.S. standard setter and would have participated in the development of new standards, but the nature of its role would have changed significantly. Rather than acting as the principal standard-setter for new standards, the FASB would have provided input and support to the IASB in its mission to develop high-quality, global standards.

In more recent years, however, the FASB and IASB have backed away almost completely from the goal of a single global accounting language because of a lack of interest in accounting convergence on the part of U.S. investors and corporations. Yet, the boards did manage to agree as recently as January 2016 on another key area—lease accounting, which along with a revenue recognition standard issued in May 2014, was thought to be one of the crowning achievements of their mutual efforts in the ongoing convergence era. Moreover, the major goals of the highly successful convergence project clearly have been achieved, with substantially improved and fully aligned U.S. and international financial reporting for business combinations, segment reporting, stock compensation, fair value measurements, borrowing costs, and noncontrolling interests, as well as leases and revenue recognition. But at its core, the fatal flaw in the U.S. side of the complete convergence plan was the huge switching cost that domestic companies and auditors would have to pay for changing their reporting language from U.S. GAAP to IFRS. Thus, it would appear the U.S. GAAP and IFRS will continue to peacefully coexist indefinitely.

The IFRS Approach

Although it is appropriate to follow the progress of these convergence developments, this text explains and illustrates only those current U.S. financial accounting and reporting standards that are necessary for you to gain a comprehension of the "big picture"—what the numbers mean from the perspective of financial statement users. However, where appropriate, IFRS standards currently in effect and under development are identified in text boxes titled "The IFRS Approach." These text boxes contain brief explanations of the relevant international standards, particularly where they differ significantly from their corresponding U.S. standards. A variety of hot topic issues affecting the accounting profession, such as those mentioned here, are discussed further in the Epilogue: "Accounting—The Future."

Exhibit 1-2 lists the website addresses of various accounting organizations. You are encouraged to visit these sites for more information about each one.

Exhibit 1-2

Websites for Accounting Organizations

American Institute of Certified Public Accountants: aicpa.org
Financial Accounting Standards Board: fasb.org
Government Accounting Standards Board: gasb.org
Institute of Internal Auditors: theiia.org
Institute of Management Accountants: imanet.org
IFRS Foundation and the International Accounting Standards Board: ifrs.org
Public Company Accounting Oversight Board: pcaob.org
Securities and Exchange Commission: sec.gov

What Does It Mean? Answer on page 27

6. What does it mean that the FASB and IASB have been working together to achieve convergence?

Ethics and the Accounting Profession

LO 1-7 Identify the key elements of ethical behavior for a professional accountant.

One characteristic frequently associated with any profession is that those practicing the profession acknowledge the importance of an ethical code. This is especially important in the accounting profession because so much of an accountant's work involves providing information to support the decisions and informed judgments made by users of accounting information.

The American Institute of Certified Public Accountants (AICPA) and the Institute of Management Accountants (IMA) both have published ethics codes. The *Code of Professional Conduct,* most recently amended in 2014, was adopted by the membership of the AICPA. The organization's bylaws state that members shall conform to the rules of the Code or be subject to disciplinary action by the AICPA. Although it doesn't have the same enforcement mechanism, the IMA's *Statement of Ethical Professional Practice* calls on management accountants to maintain the highest standards of ethical conduct as they fulfill their obligations to the organizations they serve, their profession, the public, and themselves.

Both codes of conduct identify integrity and objectivity as two key elements of ethical behavior for a professional accountant. Having **integrity** means being honest and forthright in dealings and communications with others; **objectivity** means impartiality and freedom from conflict of interest. An accountant who lacks integrity and/or objectivity cannot be relied on to produce complete and relevant information with which to make a decision or informed judgment.

Other elements of ethical behavior include independence, competence, and acceptance of an obligation to serve the best interests of the employer, the client, and the public. **Independence** is related to objectivity and is especially important to the auditor, who must be independent both in appearance and in fact. Having competence means having the knowledge and professional skills to adequately perform the work assigned. Accountants should recognize that the nature of their work requires an understanding of the obligation to serve those who will use the information communicated by them.

In the recent past, incidents involving allegations that accountants have violated their ethical codes by being dishonest, biased, and/or incompetent have been highly publicized.

That some of these allegations have been proved true should not be used to condemn all accountants. The profession has used these rare circumstances to reaffirm that the public and the profession expect accountants to exhibit a very high level of ethical behavior. In this sense, are accountants really any different from those involved in any other endeavor?

What Does It Mean? Answer on page 27

7. What does it mean to state that ethical behavior includes being objective and independent?

The Conceptual Framework

LO 1-8 Summarize the reasons for the FASB's Conceptual Framework project.

Various accounting standards have existed for many years. But it wasn't until the mid-1970s that the FASB began the process of identifying a structure or framework of financial accounting concepts. New users of financial statements can benefit from an overview of these concepts because they provide the foundation for understanding financial accounting reports. The FASB issued eight *Statements of Financial Accounting Concepts* through February 2021, the first six of which were issued between 1978 and 1985. These statements represented a great deal of effort by the FASB, and progress made on this project did not come easily.

In concert with their efforts to converge U.S. and international accounting standards, the FASB and IASB have undertaken a project to improve and converge their respective Conceptual Frameworks as well. In September 2010, *FASB Concepts Statement No. 8,* "Conceptual Framework for Financial Reporting," was issued; it included two chapters of the new Conceptual Framework and superseded *FASB Concepts Statements No. 1* and *No. 2*. In *Concepts Statement No. 8,* the FASB made the following assertions:[3]

> Concepts Statements are not part of the *FASB Accounting Standards Codification,* which is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rather, Concepts Statements describe concepts that will underlie guidance on future accounting practices and in due course will serve as a basis for evaluating existing guidance and practices.
>
> Establishment of objectives and identification of fundamental concepts will not directly solve accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.
>
> The Board itself is likely to be the most direct beneficiary of the guidance provided by Concepts Statements. They will guide the Board in developing accounting and reporting guidance by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives.[4]

Summary of *Concepts Statement No. 8,* Chapter 1: "The Objective of General Purpose Financial Reporting"

LO 1-9 Summarize the objective of general-purpose financial reporting.

To set the stage more completely for your study of financial accounting, it is appropriate to have an overview of the foundational building blocks of financial reporting, as expressed in Chapter 1 of *Concepts Statement No. 8.* (To gain a comprehensive

[3] FASB, Statement of Financial Accounting Concepts No. 8, Preface (Stamford, CT, 2010). Copyright the Financial Accounting Foundation, High Ridge Park, Stamford, CT 06905, U.S.A. Excerpted with permission. Copies of the complete document are available from the FASB.

[4] FASB, Statement of Financial Accounting Concepts No. 8, Preface.

Business in
Practice

Business Ethics

Events like the 2008–2009 global economic crisis highlight the necessity of sound ethical practices across the business world. An indication of the breadth of this concern was the development of the term ***stakeholder*** to refer to the many entities—owners/stockholders, managers, employees, customers, suppliers, communities, and even competitors—who have a stake in the way an organization conducts its activities. Another indicator of this concern is that business ethics and corporate social responsibility issues have merged into a single broad area of interest.

This concern is international in scope and is attracting political attention. In 2020, the Caux Round Table (CRT) for Moral Capitalism celebrated its 26th year of leadership in corporate business ethics after publishing its *Principles for Business* in 1994, which attempts to express a worldwide standard for ethical and socially responsible corporate behavior. Another influential organization is Business for Social Responsibility (BSR), a U.S.-based global resource for companies seeking to sustain their commercial success in ways that demonstrate respect for ethical values and for people, communities, and the environment. For more information, visit cauxroundtable.org or bsr.org.

The Foreign Corrupt Practices Act of 1977, as amended by the International Anti-Bribery and Fair Competition Act of 1998, has certainly contributed to a management focus on ethical behavior—although government regulation, in and of itself, tends to curtail only the most abusive ethical violations. As early as 1987, a private-sector commission was convened in response to perceived weaknesses in corporate financial reporting practices. This resulted in a series of recommendations to the SEC that publicly owned corporations include in their annual reports disclosures about how the company fulfills its responsibilities for achieving a broadly defined set of internal control objectives related to safeguarding assets, authorizing transactions, and reporting properly. (See the Business in Practice discussion of internal control in Chapter 5.) Section 404 of the Sarbanes–Oxley Act of 2002 requires all SEC-regulated companies to include in their annual reports a report by management on the effectiveness of the company's internal control over financial reporting. The auditor that audits the company's financial statements included in the annual report is also required to attest to and report on management's assessment of internal controls. Many companies provide further disclosures in their annual reports concerning their corporate code of conduct or ethics and whistleblower systems. Within the accounting profession, it is generally accepted that an organization's integrity and ethical values bear directly on the effectiveness of its internal control system.

Researchers have demonstrated that well-constructed ethical and social programs can contribute to profitability by helping to attract customers, raise employee morale and productivity, and strengthen trust relationships within the organization. Indeed, organizations that are committed to ethical quality often institute structures and procedures (such as codes of conduct) to encourage decency. Ethics codes vary from generalized value statements and credos to detailed discussions of global ethical policy. Johnson & Johnson's "Our Credo" is perhaps the most frequently cited corporate ethics statement, and rightfully so (see jnj.com/credo).

For a list of the 100 Best Corporate Citizens as determined by one observer of the corporate scene, see 100best.3blmedia.com. Incidentally, Campbell's was ranked 35th on the 2020 list, which was led by Owens Corning, Citi, General Mills, Cisco, HP, Intel, Ecolab, General Motors, Hess, and Accentuate as the top 10.

Campbell's

For additional guidance, check out US SIF (The Forum for Sustainable and Responsible Investment), which offers comprehensive information, contacts, and resources on socially responsible investing (see ussif.org).

It is never too early to understand and refine your own value system and to sharpen your awareness of the ethical dimensions of your activities, and don't be surprised if you are asked to literally "sign on" to an employer's code of conduct.

The following websites reference other sites dealing with business ethics:

scu.edu/ethics (then click on *Business Ethics* in the *Focus Areas* drop down menu).
ethics.org

Study
Suggestion

At this point, it is unlikely that you will fully grasp and retain all of the details expressed here. Don't try to memorize these summary highlights! Instead, read through this material to get a basic understanding of what the accounting profession is "gearing toward." That way, as specific applications of these concepts are presented later in the course, you will have a basis for comparison, and you won't be surprised very often.

understanding of the author summary that follows, you may want to download the full text of *Concepts Statement No. 8* from the FASB's website.)

Financial reporting is done for individual firms, or entities, rather than for industries or the economy as a whole. It is aimed primarily at meeting the needs of external users of accounting information who would not otherwise have access to the firm's records. Investors, creditors, and financial advisers are the primary users who create the demand for accounting information. Financial reporting is designed to meet the needs of users by providing information that is relevant to making rational investment and credit decisions and other informed judgments. The users of accounting information are assumed to be reasonably astute in business and financial reporting practices. However, each user reads the financial statements with her or his own judgment and biases and must be willing to take responsibility for her or his own decision making.

Most users are on the outside looking in. For its own use, management can prescribe the information it wants. Reporting for *internal* planning, control, and decision making need not be constrained by financial reporting requirements—thus the Concepts Statements are not directed at internal (i.e., managerial) uses of accounting information.

Financial accounting is historical scorekeeping; it is not future oriented. Although the future is unknown, it is likely to be influenced by the past. To the extent that accounting information provides a fair basis for the evaluation of past performance, it may be helpful in assessing an entity's future prospects. However, financial reports are not the sole source of information about an entity. For example, a potential employee might want to know about employee turnover rates, which are not disclosed in the financial reporting process. The information reported in financial accounting relates primarily to past transactions and events that can be measured in dollars and cents.

Financial accounting information is developed and used at a cost, and the benefit to the user of accounting information should exceed the cost of providing it.

Many of the objectives of financial reporting relate to the presentation of earnings and cash flow information. Investors and creditors are interested in making judgments about the firm's profitability and whether they are likely to receive payment of amounts owed to them. The user may ask, "How much profit did the firm earn during the year ended December 31, 2022?" or "What was the net cash inflow from operating the firm for the year?" Users understand that cash has to be received from somewhere before the firm can pay principal and interest to its creditors or dividends to its investors. A primary objective of financial reporting is to provide timely information about a firm's earnings and cash flow.

Financial reporting includes detailed notes and other disclosures.

Accrual accounting—to be explained in more detail later—involves accounting for the effect of an economic activity, or transaction, on an entity when the activity has occurred, rather than when the cash receipt or payment takes place. Thus, the company you work for reports a cost for your wages in the month in which you do the work, even though you may not be paid until the next month. Earnings information is reported on the accrual basis rather than the cash basis because past performance can be measured more accurately under accrual accounting. In the process of measuring a firm's accrual accounting earnings, some costs applicable to one year's results of operations may have to be estimated; for example, product warranty costs applicable to 2022 may not be finally determined until 2023. Reporting an approximately correct amount in 2022 is obviously preferable to recording nothing at all until 2023, when the precise amount is known.

In addition to providing information about earnings and cash flows, financial reporting should provide information to help users assess the relative strengths and weaknesses of a firm's financial position. The user may ask, "What economic resources does the firm own? How much does the firm owe? What caused these amounts to change over time?" Financial accounting does not attempt to directly measure the value of a firm, although it can be used to facilitate the efforts of those attempting to achieve such an objective. The numbers reported in a firm's financial statements do not change just because the market price of its stock changes.

Financial accounting standards are still evolving; with each new update to the FASB Codification, accounting procedures are modified to mirror new developments in the business world as well as current views and theories of financial reporting. At times, the FASB finds it difficult to keep pace with the ever-changing economic activities addressed by its ASUs. Fortunately, however, such efforts have resulted in improved financial reporting practices each step along the way.

Students of accounting should be aware that the how-to aspects of accounting are not static; the accounting discipline is relatively young in comparison to other professions and is in constant motion. Perhaps the most important outcome of the conceptual framework project is the sense that the profession now has a blueprint in place that will carry financial reporting into the future.

8. What does it mean to state that the objectives of financial reporting given in *Statement of Financial Accounting Concepts No. 8* provide a framework for this text?

What Does It Mean?

Answer on page 27

Objectives of Financial Reporting for Nonbusiness Organizations

At the outset of this chapter, it was stated that the material to be presented, although usually to be expressed in the context of profit-seeking business enterprises, would also be applicable to not-for-profit social service and governmental organizations. The FASB's "Highlights" of *Concepts Statement No. 4,* "Objectives of Financial Reporting by Nonbusiness Organizations," states, "Based on its study, the Board believes that the objectives of general-purpose external financial reporting for government-sponsored entities (e.g., hospitals, universities, or utilities) engaged in activities that are not unique to government should be similar to those of business enterprises or other nonbusiness organizations engaged in similar activities."[5] *Statement 6* amended *Statement 2* by affirming that the qualitative characteristics described in *Statement 2* apply to the information about both business enterprises and not-for-profit organizations.

[5] FASB, Statement of Financial Accounting Concepts No. 4.

The objectives of financial reporting for nonbusiness organizations focus on providing information for resource providers (such as taxpayers to governmental entities and donors to charitable organizations), rather than investors. Information is provided about the economic resources, obligations, net resources, and performance of an organization during a period of time. Thus, even though nonbusiness organizations have unique characteristics that distinguish them from profit-oriented businesses, the information characteristics of the financial reporting process for each type of organization are similar.

It will be appropriate to remember the gist of the preceding objectives as individual accounting and financial statement issues are encountered in subsequent chapters and are related to real-world situations.

Plan of the Book

LO 1-10
Describe the plan of the book.

This text is divided into two main parts. Chapters 2 through 11, which compose the first part of the book, are devoted to financial accounting topics. The remaining chapters, Chapters 12 through 16, provide an in-depth look at managerial accounting.

As you study the topics that lie ahead, the authors believe it will be to your advantage to be aware of the organizational strategy that we followed in writing this book. In general, the coverage of each topic begins with a "big picture" designed to put the topic in perspective relative to its role in financial accounting and reporting (Chapters 2 through 11) and managerial analysis and decision making (Chapters 12 through 16). The text coverage is limited in detail and is designed to provide a broad "high spot" understanding of the material and a foundation for further learning in a more advanced academic environment or experiential setting. You are quite likely to encounter certain situations in practice that do not follow exactly this textbook's descriptions of accounting practices. Yet we are confident that your own thoughtful study, and practical input from others who do accounting-related work and use its results, will permit you to refine your knowledge and use this material effectively.

Chapter 2, which kicks off our discussion of financial accounting, describes financial statements, presents a model of how they are interrelated, and briefly summarizes key accounting concepts and principles. This is a "big picture" chapter; later chapters elaborate on most of the material introduced here. This chapter also includes four Business in Practice features. As you have seen from the features in this chapter, these are brief explanations of business practices that make some of the ideas covered in the text easier to understand.

Chapter 3 describes some of the basic analytical tools that allow financial statement users to make fundamental interpretations of a company's financial position and results of operations. This is a "big picture" chapter that merely scratches the surface of financial statement analysis; a more complete explanation of the key financial statement relationships is presented in subsequent chapters. Understanding the basic relationships presented here permits better comprehension of the impact of alternative accounting methods discussed in Chapters 4 through 10. However, because Chapter 11 presents a more comprehensive treatment of financial statement analysis, some instructors may prefer to cover the Chapter 3 material with that of Chapter 11.

Chapter 4 describes the bookkeeping process and presents a powerful transaction analysis model. Using this model, the financial statement user can understand the effect of any transaction on the statements, and many of the judgments based on the statements. You will not be asked to learn detailed bookkeeping procedures in this chapter.

Chapters 5 through 9 examine specific financial statement elements. Chapter 5 describes the accounting for short-term *(current)* assets, including cash, accounts and notes receivable, inventory, and prepaid items. Chapter 6 describes the accounting for long-term assets—including land, buildings and equipment—and a variety of intangible assets and natural resources. Chapter 7 discusses the accounting issues related to current and long-term liabilities, including accounts and notes payable, bonds payable, and deferred income taxes. Chapter 8 deals with the components of stockholders' equity, including common stock, preferred stock, retained earnings, and treasury stock. Chapter 9 presents a comprehensive view of the income statement and the statement of cash flows.

Chapter 10 covers corporate governance issues as well as the notes to the financial statements, and Chapter 11 concludes our look at financial accounting with a detailed discussion of financial statement analysis. The financial accounting chapters frequently make reference to Campbell Soup Company's 2020 annual report, appropriate elements of which are reproduced in the appendix. You should refer to those financial statements and notes, as well as other company financial reports you may have, to get acquainted with actual applications of the issues being discussed in the text.

Campbell's

Following Chapter 11, we turn our focus to managerial accounting topics. Chapter 12 presents the "big picture" of managerial accounting. It contrasts financial and managerial accounting; introduces key managerial accounting terminology; and illustrates cost behavior patterns by describing various applications of cost–volume–profit analysis, including the calculation of a firm's breakeven point in units and sales dollars. Chapter 13 describes the principal cost accounting systems used in business today, with emphasis on the cost accumulation and assignment activities carried out by most firms. Chapter 14 illustrates many aspects of a typical firm's operating budget, including the sales forecast, production and purchases budgets, and the cash budget, as well as the development and use of standard costs for planning purposes. Chapter 15 concentrates on cost analysis for control; it highlights a number of performance reporting techniques and describes the analysis of variances for raw materials, direct labor, and manufacturing overhead. Chapter 16 concludes our discussion of managerial accounting with an overview of short-run versus long-run decision making, including a demonstration of the payback, net present value, and internal rate of return techniques used to support capital budgeting decisions.

An epilogue titled "Accounting—The Future" (read only, with no homework assignments!) reemphasizes the evolutionary nature of the accounting discipline and the relationships between financial and managerial accounting, and calls students' attention to a world of possibilities that remain to be explored in the future.

Use each chapter's learning objectives, "What Does It Mean?" questions, summary, and glossary of key terms and concepts to help manage your learning. With reasonable effort, you will achieve your objective of becoming an effective user of accounting information to support the related decisions and informed judgments you will make throughout your life.

Summary

Accounting is the process of identifying, measuring, and communicating economic information about an entity for the purpose of making decisions and informed judgments. **(LO 1-1)**

Users of financial statements include management, investors, creditors, employees, and government agencies. Decisions made by users relate to, among other things, entity operating results, investment and credit questions, employment characteristics, and compliance with laws. Financial statements support these decisions because they communicate important financial information about the entity. **(LO 1-2)**

The major classifications of accounting include financial accounting, managerial accounting/cost accounting, auditing/public accounting, internal auditing, governmental and not-for-profit accounting, and income tax accounting. **(LO 1-3)**

Accounting has developed over time in response to the information needs of users of financial statements. Financial accounting standards have been established by different organizations over the years. These standards have become increasingly complex in recent decades and, in some cases, are now extremely specific almost to the point of being statute-like. As a result, interest in converging U.S. financial reporting standards with International Financial Reporting Standards, which are more general and flow from broad principles, increased greatly beginning in the late 1990s. The Securities and Exchange Commission, the Financial Accounting Standards Board, and the International Accounting Standards Board have made substantial progress on the so-called convergence project that promises to make the existing financial reporting standards fully compatible as soon as possible. Currently in the United States, the FASB is the standard-setting body for financial accounting and is likely to remain so indefinitely. Other organizations are involved in establishing standards for cost accounting, auditing, governmental accounting, and income tax accounting. **(LO 1-4, 1-5, 1-6)**

Integrity, objectivity, independence, and competence are several characteristics of ethical behavior required of a professional accountant. High standards of ethical conduct are appropriate for all people, but professional accountants have a special responsibility because so many people make decisions and informed judgments using information provided by the accounting process. **(LO 1-7)**

The Financial Accounting Standards Board has issued several *Statements of Financial Accounting Concepts* resulting from the Conceptual Framework project that began in the late 1970s and still receives attention today. These statements describe concepts and relations that will underlie future financial accounting standards and practices and will in due course serve as a basis for evaluating existing standards and practices. Efforts are under way to ensure that the FASB and IASB Conceptual Frameworks will be converged similarly to the way in which their respective accounting standards have been converged. **(LO 1-8)**

Highlights of the Concepts Statement dealing with the objectives of financial reporting provide that financial information should be useful to investor and creditor concerns about the cash flows of the enterprise, the resources and obligations of the enterprise, and the profit of the enterprise. Financial accounting is not designed to directly measure the value of a business enterprise. **(LO 1-9)**

The objectives of financial reporting for nonbusiness enterprises are not significantly different from those for business enterprises, except that resource providers, rather than investors, are concerned about performance results, rather than profit.

The book starts with the big picture of financial accounting and then moves to some of the basic financial interpretations made from accounting data. An overview of the bookkeeping process is followed by a discussion of specific financial statement elements and notes to the financial statements. The financial accounting material ends with a chapter focusing on financial statement analysis and use of the data developed from analysis. The managerial accounting chapters focus on the development and use of financial information for managerial planning, control, and decision making. **(LO 1-10)**

Key Terms and Concepts

accounting (p. 3) The process of identifying, measuring, and communicating economic information about an organization for the purpose of making decisions and informed judgments.

***Accounting Standards Update* (Update or ASU) (p. 10)** A transient document which communicates the details of specific amendments to the FASB Codification, and explains the basis for the Board's decisions. Although ASUs update the FASB Codification, the FASB does not consider Updates as authoritative in their own right.

accrual accounting (p. 18) Accounting that recognizes revenues and expenses as they occur, even though the cash receipt from the revenue or the cash disbursement related to the expense may occur before or after the event that causes revenue or expense recognition.

annual report (p. 8) A document distributed to shareholders and other interested parties that contains the financial statements, notes to the financial statements, and management's discussion and analysis of financial and operating factors that affected the firm together with the report of the external auditor's examination of the financial statements.

auditing (p. 7) The process of examining the financial statements of an entity by an independent third party with the objective of expressing an opinion about the fairness of the presentation of the entity's financial position, results of operations, changes in financial position, and cash flows. The practice of auditing is less precisely referred to as *public accounting.*

bookkeeping (p. 6) Procedures that are used to keep track of financial transactions and accumulate the results of an entity's financial activities.

cash flow (p. 6) Cash receipts or disbursements of an entity.

Certified Management Accountant (CMA) (p. 7) Professional designation earned by passing a broad, two-part examination and meeting certain experience requirements. Examination topics include budgeting, performance management, cost management, financial statement analysis, corporate finance, decision analysis, and professional ethics.

Certified Public Accountant (CPA) (p. 6) A professional designation earned by fulfilling certain education and experience requirements, in addition to passing a comprehensive, four-part examination. Examination topics include financial accounting theory and practice, income tax accounting, managerial accounting, governmental and not-for-profit accounting, auditing, business law, and other aspects of the business environment.

controller (p. 6) The job title of the person who is the chief accounting officer of an organization. The controller is usually responsible for both the financial and managerial accounting functions. Sometimes referred to as *comptroller.*

cost accounting (p. 7) A subset of both financial and managerial accounting that relates to the accumulation and determination of product, process, or service costs.

Cost Accounting Standards Board (CASB) (p. 12) A group authorized by the U.S. Congress to establish cost accounting standards for government contractors.

creditor (p. 4) An organization or individual who lends to the entity. Examples include suppliers who ship merchandise to the entity prior to receiving payment for their goods and banks that lend cash to the entity.

entity (p. 3) An organization, individual, or a group of organizations or individuals for which accounting services are performed.

***FASB Accounting Standards Codification* (FASB Codification) (p. 10)** An advanced user-accessible computer application that systemized and reorganized many divergent elements of U.S. GAAP into one composite structure permitting users to review, study, and research topics. The Codification presents U.S. GAAP in a uniform and logical order, with approximately 90 major accounting topics. Since July 2009, the FASB Codification has represented a single source of all U.S. GAAP.

financial accounting (p. 6) Accounting that focuses on reporting an entity's financial position at a point in time and/or its results of operations and cash flows for a period of time.

Financial Accounting Foundation (FAF) (p. 10) An organization composed of people from the public accounting profession, businesses, and the public that is responsible for the funding of and the appointment of members to the Financial Accounting Standards Board and the Governmental Accounting Standards Board.

Financial Accounting Standards Board (FASB) (p. 10) The body responsible for establishing U.S. generally accepted accounting principles.

generally accepted accounting principles (GAAP) (p. 7) Pronouncements of the Financial Accounting Standards Board (FASB) and its predecessors that constitute appropriate accounting for various transactions used for reporting financial position and results of operations to investors and creditors. Since July 2009, the FASB Codification has represented a single source of U.S. GAAP.

generally accepted auditing standards (GAAS) (p. 7) Standards for auditing that are established by the Auditing Standards Board of the American Institute of Certified Public Accountants unless superseded or amended by the PCAOB.

Governmental Accounting Standards Board (GASB) (p. 12) Established by the Financial Accounting Foundation to develop guidelines for financial accounting and reporting by state and local governmental units.

independence (p. 15) The personal characteristic of an accountant, especially an auditor, that refers to both appearing and in fact being objective and impartial.

independent auditor's report (p. 7) The report accompanying audited financial statements that explains briefly the auditor's responsibility and the extent of work performed. The report includes an opinion about whether the information contained in the financial statements is presented fairly in accordance with generally accepted accounting principles.

integrity (p. 15) The personal characteristic of honesty, including being forthright in dealings and communications with others.

internal auditing (p. 8) The practice of auditing within a company by employees of the company.

International Accounting Standards Board (IASB) (p. 11) Standard-setting body responsible for the development of International Financial Reporting Standards (IFRS), permitted or required by more than 120 countries.

International Financial Reporting Standards (IFRS) (p. 13) Pronouncements of the International Accounting Standards Board that are considered to be a "principles-based" set of standards in that they establish broad rules as well as dictate specific treatments. Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS).

investor (p. 4) An organization or individual who has an ownership interest in the firm. For corporations, referred to as *stockholder* or *shareholder.*

managerial accounting (p. 7) Accounting that is concerned with the internal use of economic and financial information to plan and control many of the activities of an entity and to support the management decision-making process.

objectivity (p. 15) The personal characteristic of impartiality, including freedom from conflict of interest.

public accounting (p. 7) The segment of the accounting profession that provides auditing, income tax accounting, and management consulting services to clients.

Public Company Accounting Oversight Board (PCAOB) (p. 11) Established in 2002 with authority to set and enforce auditing and ethics standards for public companies and their auditing firms; affiliated with the SEC.

Securities and Exchange Commission (SEC) (p. 10) A unit of the federal government that is responsible for establishing regulations and ensuring full disclosure to investors about companies and their securities that are traded in interstate commerce.

***Statements of Financial Accounting Standards* (SFAS) (p. 10)** Pronouncements of the Financial Accounting Standards Board that formerly constituted generally accepted accounting principles. Effective in July 2009, the SFAS series was superseded by the *FASB Accounting Standards Codification.*

Exercises

McGraw Hill connect

Exercise 1.1

Obtain an annual report. Throughout this course, you will be asked to relate the material being studied to actual financial statements. After you complete this course, you will be able to use an organization's financial statements to make decisions and informed judgments about that organization. The purpose of this assignment is to provide the experience of obtaining a company's annual report. You may want to refer to the financial statements in the report during the rest of the course.

Required:

Obtain the most recently issued annual report of a publicly owned manufacturing or merchandising corporation of your choice. Do not select a bank, insurance company, financial institution, or public utility. It would be appropriate to select a firm that you know something about or have an interest in.

Type www.firmname.com or use a search engine to locate your chosen company's website and then scan your firm's home page for information about annual report ordering. If you don't see a direct link to *Investor Relations* or *Investors* on the home page, look for links such as *Our Company, About Us,* or *Site Map* that may lead you to *SEC Filings, Financial Information,* or *Annual Reports.* Most companies allow you to save or print an Adobe Acrobat version of their annual reports.

Exercise 1.2
LO 1-4

Read and outline an article. The accounting profession is frequently in the news, not always in the most positive light. The purpose of this assignment is to increase your awareness of an issue facing the profession.

Required:

Find, read, outline, and prepare to discuss a brief article from a general audience or business audience publication about accounting and/or the accounting profession. The article should have been published within the past eight months and should relate to accounting or the accounting profession in general; it should *not* be about some technical accounting issue. The appropriate search terms to use are "accountants," "accounting," and/or "accounting (specific topic)."

Exercise 1.3
LO 1-3

Your ideas about accounting. Write a paragraph describing your perceptions of what accounting is all about and the work that accountants do.

Exercise 1.4
LO 1-10

Your expectations for this course. Write a statement identifying the expectations you have for this course.

Exercise 1.5
LO 1-7

Identify factors in an ethical decision. Jim Sandrolini is an accountant for a local manufacturing company. Jim's good friend, Dan Carruthers, has been operating a retail sporting goods store for about a year. The store has been moderately successful, and Dan needs a bank loan to help finance the next stage of his store's growth. He has asked Jim to prepare financial statements that the banker will use to help decide whether to grant the loan. Dan has proposed that the fee he will pay for Jim's accounting work should be contingent upon his receiving the loan.

Required:
What factors should Jim consider when making his decision about whether to prepare the financial statements for Dan's store?

Exercise 1.6
LO 1-2

Identify information used in making an informed decision. Chris and Tiasha Hirst have owned and operated a retail furniture store for more than 30 years. They have employed an independent CPA during this time to prepare various sales tax, payroll tax, and income tax returns, as well as financial statements for themselves and the bank from which they have borrowed money from time to time. They are considering selling the store but are uncertain about how to establish an asking price.

Required:
What type of information is likely to be included in the material prepared by the CPA that may help Mr. and Mrs. Hirst establish an asking price for the store?

Exercise 1.7
LO 1-6

Auditor independence. Using the search engine you are most comfortable with, identify at least five sources concerning the general topic of auditor independence. Write a brief memo to provide an update on the current status of the auditor independence standard-setting process. The Business in Practice box on auditor independence should serve as the starting point for this exercise. (*Note:* You might find it useful to contrast the opinions expressed by any of the Big 4 accounting firms to those expressed by nonaccounting professionals.)

Exercise 1.8

Find financial information. From the set of financial statements acquired for E1.1, determine the following:

a. Who is the chief financial officer?
b. What are the names of the directors?
c. Which firm conducted the audit? Have the auditors reviewed the entire report?
d. What are the names of the financial statements provided?
e. How many pages of notes accompany the financial statements?
f. In addition to the financial statements, are there other reports? If so, what are they?

Answers to What Does It Mean?

1. It means that accounting is a service activity that helps many different users of accounting information who use the information in many ways.
2. It means to perform professional services for clients principally in the areas of auditing, income taxes, management consulting, and/or accounting systems evaluation and development.
3. It means that the individual has met the educational requirements and has passed the uniform examination. Subsequently, the individual has met the experience requirements and has applied for and been issued a license by a state board of accountancy granting the individual the right to practice as a Certified Public Accountant.
4. It means that generally accepted accounting principles sometimes permit alternative ways of accounting for identical transactions, thus requiring professional judgment, and that these principles are still evolving.
5. It means that the FASB has completed an extensive process of research and development, including receiving input from interested individuals and organizations, and has made an authoritative pronouncement (i.e., an Update to the FASB Codification) that defines accounting and reporting for a specific activity or transaction and becomes a generally accepted accounting principle.
6. It means that the FASB is committed to working with the IASB to ensure that a solution can be reached whereby U.S. accounting standards will eventually be merged with international accounting standards to the greatest extent possible.
7. It means that the individual is impartial, free from conflict of interest, and will not receive an undisclosed personal gain from the activity in which she or he is involved.
8. It means that the accounting and financial reporting topics explained in the financial accounting part of this text should

   a. Relate to external financial reporting.
   b. Support business and economic decisions.
   c. Provide information about cash flows.
   d. Focus on earnings based on accrual accounting.
   e. Not seek to directly measure the value of a business enterprise.
   f. Report information that is subject to evaluation by individual financial statement users.

2 Financial Statements and Accounting Concepts/Principles

Financial statements are the product of the financial accounting process. They are the means of communicating economic information about the entity to individuals who want to make decisions and informed judgments about the entity's financial position, results of operations, and cash flows. Although each of the four principal financial statements has a unique purpose, they are interrelated; to get a complete financial picture of the reporting entity, all must be considered.

Users cannot make meaningful interpretations of financial statement data without understanding the concepts and principles that relate to the entire financial accounting process. It is also important for users to understand that these concepts and principles are broad in nature; they do not constitute an inflexible set of rules, but serve as guidelines for the development of sound financial reporting practices.

LEARNING OBJECTIVES

After studying this chapter, you should understand and be able to

LO 2-1 Explain what transactions are.

LO 2-2 Identify and explain the kind of information reported in each financial statement and describe how financial statements are related to each other.

LO 2-3 Explain the meaning and usefulness of the accounting equation.

LO 2-4 Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

LO 2-5 Identify and explain the broad, generally accepted concepts and principles that apply to the accounting process.

LO 2-6 Discuss why investors must carefully consider cash flow information in conjunction with accrual accounting results.

LO 2-7 Identify and explain several limitations of financial statements.

LO 2-8 Describe what a corporation's annual report is and why it is issued.

Financial Statements

From Transactions to Financial Statements

LO 2-1 Explain what transactions are.

An entity's financial statements are the end product of a process that starts with **transactions** between the entity and other organizations and individuals. Transactions are economic interchanges between entities: for example, a sale/purchase or a receipt of cash by a borrower and the payment of cash by a lender. The flow from transactions to financial statements can be illustrated as follows:

Transactions → [Procedures for sorting, classifying, and presenting (bookkeeping)
Selection of alternative methods of reflecting the effects of certain transactions (accounting)] → Financial statements

What Does It Mean? Answer on page 66

1. What does it mean to say that there has been an accounting transaction between you and your school? Give an example of such a transaction.

Transactions are summarized in **accounts**, and accounts are further summarized in the financial statements. In this sense, transactions can be seen as the bricks that build the financial statements. By learning about the form, content, and relationships among financial statements in this chapter, you will better understand the process of building those results—bookkeeping and transaction analysis—described in Chapter 4 and subsequent chapters.

Current generally accepted accounting principles and auditing standards require that the financial statements of an entity show the following for the reporting period:

Financial position at the end of the period.
Earnings for the period.
Cash flows during the period.
Investments by and distributions to owners (i.e., stockholders) during the period.

The financial statements that satisfy these requirements are, respectively, the

Balance sheet (or statement of financial position).
Income statement (or statement of earnings, or profit and loss statement, or statement of operations).
Statement of cash flows.
Statement of changes in stockholders' equity (or statement of stockholders' equity, or statement of equity, or statement of changes in capital stock, or statement of changes in retained earnings).

In addition to the financial statements themselves, the annual report will probably include several accompanying notes (sometimes called the financial review) that include explanations of the accounting policies and detailed information about many of the amounts and captions shown on the financial statements. These notes are

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designed to assist the reader of the financial statements by disclosing as much relevant supplementary information as the company and its auditors deem necessary and appropriate. For Campbell Soup Company, the notes to the 2020 financial statements are shown in the "Notes to Consolidated Financial Statements" section of the annual report, a complete copy of which can be downloaded from the company's website. One of this text's objectives is to enable you to read, interpret, and understand financial statement notes. Chapter 10 describes the notes to the financial statements in detail.

Business in Practice

Organizing a Business

There are three principal forms of business organization: proprietorship, partnership, and corporation.

A **proprietorship** is an activity conducted by an individual. Operating as a proprietorship is the easiest way to get started in a business activity. Other than the possibility of needing a local license, there aren't any formal prerequisites to beginning operations. Besides being easy to start, a proprietorship has the advantage, according to many people, that the owner is his or her own boss. A principal disadvantage of the proprietorship is that the owner's liability for business debts is not limited by the assets of the business. For example, if the business fails, and if after all available business assets have been used to pay business debts the business creditors are still owed money, the owner's personal assets can be claimed by business creditors. Another disadvantage is that the individual proprietor may have difficulty raising the money needed to provide the capital base that will be required if the business is to grow substantially. Because of the ease of getting started, every year many business activities begin as proprietorships.

The **partnership** is essentially a group of proprietors who have banded together. The unlimited liability characteristic of the proprietorship still exists, but with several partners the ability of the firm to raise capital may be improved. Income earned from partnership activities is taxed at the individual partner level; the partnership itself is not a tax-paying entity. Accountants, attorneys, and other professionals frequently operate their firms as partnerships. In recent years, many large professional partnerships, including the Big 4 accounting firms, have been operating under *limited liability partnership* (LLP) rules, which shield individual partners from unlimited personal liability.

Most large businesses, and many new businesses, use the corporate form of organization. Note that "Inc." in the name of our example business, Main Street Stores Inc., is an abbreviation for *incorporated* and means that the firm was legally organized as a corporation. The owners of the corporation are called **stockholders** (or shareholders). They have invested funds in the corporation and received shares of **stock** as evidence of their ownership. Stockholders' liability is limited to the amount invested; creditors cannot seek recovery of losses from the personal assets of stockholders. Large amounts of capital can frequently be raised by selling shares of stock to many individuals. It is also possible for all of the stock of a corporation to be owned by a single individual. A stockholder can usually sell his or her shares to other investors or buy more shares from other stockholders if a change in ownership interest is desired. A **corporation** is formed by having a charter and bylaws prepared and registered with the appropriate office in 1 of the 50 states. The cost of forming a corporation is usually greater than that of starting a proprietorship or forming a partnership. A major disadvantage of the corporate form of business is that corporations are taxpaying entities. Thus, any income distributed to stockholders has been taxed first as income of the corporation and then is taxed a second time as income of the individual stockholders.

A form of organization that has now been authorized in all states and the District of Columbia is the *limited liability company* (LLC). For accounting and legal purposes, this type of organization is treated as a corporation even though some of the formalities of the corporate form of organization are not present. Stockholders of small corporations may find that banks and major creditors usually require the personal guarantees of the principal stockholders as a condition for granting credit to the corporation. Therefore, the limited liability of the corporate form may be, in the case of small corporations, more theoretical than real.

Business in
Practice

Fiscal Year

A firm's **fiscal year** is the annual period used for reporting to owners, the government, and others. Many firms select the calendar year as their fiscal year, but other 12-month periods can also be selected. Some firms select a reporting period ending on a date when inventories will be relatively low or business activity will be slow, because this facilitates the process of preparing financial statements.

Many firms select fiscal periods that relate to the pace of their business activity. Food retailers, for example, have a weekly operating cycle, and many of these firms select a 52-week fiscal year (with a 53-week fiscal year every five or six years so their year-end remains near to the same date every year). Campbell Soup Company has adopted this strategy; note, in the appendix, that Campbell's fiscal year ends on the Sunday nearest July 31 each year. (There were 53 weeks in 2020 and 52 weeks in 2019 and 2018; the last fiscal year with 53 weeks prior to 2020 was 2014.)

For internal reporting purposes, many firms use periods other than the month (e.g., 13 four-week periods). Such firms want to maintain the same number of operating days in each period so that comparisons between the same periods of different years can be made without having to consider differences in the number of operating days in the respective periods.

Campbell's

Financial Statements Illustrated

LO 2-2
Identify and explain the kind of information reported in each financial statement and describe how the statements are related to each other.

To illustrate financial statements, we present an example of what they might look like for a simple retail business. Main Street Store Inc. was organized as a corporation and began business during September 2022 (see Business in Practice—Organizing a Business). The company buys clothing and accessories from distributors and manufacturers and sells these items from a rented building. The financial statements of Main Street Store Inc. at August 31, 2023, and for the fiscal year (see Business in Practice—Fiscal Year) ended on that date are presented in Exhibits 2-1, 2-2, 2-3, and 2-4.

As you look at these financial statements, you will probably have several questions concerning the nature of specific accounts and how the numbers are computed. For now, concentrate on the explanations and definitions that are appropriate and inescapable, and notice especially the characteristics of each financial statement. Many of your questions about specific accounts will be answered in subsequent chapters that explain in detail the individual statements and their components.

Explanations and Definitions

Balance Sheet The **balance sheet** is a listing of the organization's assets, liabilities, and stockholders' equity (often referred to simply as *owners' equity*) *at a point in time*. In this sense, the balance sheet is like a snapshot of the organization's financial position, frozen at a specific point in time. The balance sheet is sometimes called the **statement of financial position** because it summarizes the entity's resources (assets), obligations (liabilities), and owners' claims (stockholders' equity). The balance sheet for Main Street Store Inc. at August 31, 2023, the end of the firm's first year of operations, is illustrated in Exhibit 2-1.

LO 2-3
Explain the meaning and usefulness of the accounting equation.

Notice the two principal sections of the balance sheet that are shown side by side: (1) assets and (2) liabilities and stockholders' equity. Observe that the dollar total of \$320,000 is the same for each side. This equality is sometimes referred to as the

Exhibit 2-1

Balance Sheet

MAIN STREET STORE INC.
Balance Sheet
August 31, 2023

Assets		**Liabilities and Stockholders' Equity**	
Current assets:		Current liabilities:	
Cash	$ 34,000	Accounts payable	$ 35,000
Accounts receivable	80,000	Other accrued liabilities	12,000
Merchandise inventory	170,000	Short-term debt	20,000
Total current assets	$284,000	Total current liabilities	$ 67,000
Plant and equipment:		Long-term debt	50,000
Equipment	40,000	Total liabilities	$117,000
Less: Accumulated depreciation	(4,000)	Stockholders' equity	203,000
Total assets	$320,000	Total liabilities and stockholders' equity	$320,000

accounting equation or the **balance sheet equation**. It is the equality, or balance, of these two amounts from which the term *balance sheet* is derived.

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' equity}$$
$$\$320{,}000 = \$117{,}000 + \$203{,}000$$

Now we will provide some of those appropriate and inescapable definitions and explanations:

"**Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[1] In brief, assets represent the amount of resources controlled (which ordinarily means owned) by the entity. Assets are often tangible; they can be seen and handled (such as cash, merchandise inventory, or equipment), or evidence of their existence can be observed (such as a customer's acknowledgment of receipt of merchandise and the implied promise to pay the amount due when agreed upon—an account receivable).

"**Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."[2] In brief, liabilities are amounts *owed* to other entities. For example, the accounts payable arose because suppliers shipped merchandise to Main Street Store Inc., and this merchandise will be paid for at some point in the future. In other words, the supplier has a "claim" against the firm for the amount Main Street Store Inc. has agreed to pay for the merchandise until the day it is paid for and, thus, has become a creditor of the firm by supplying merchandise on account.

Stockholders' equity (often referred to as **owners' equity**) is the ownership right of the stockholder(s) of the entity in the assets that remain after deducting the liabilities. (A car or house owner refers to his or her **equity** as the market value of the car or

[1] Source: FASB, Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements."
[2] Source: FASB, Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements."

house less the loan or mortgage balance.) Stockholders' equity is sometimes referred to as **net assets**. This can be shown by rearranging the basic accounting equation:

$$\text{Assets} - \text{Liabilities} = \text{Stockholders' equity}$$
$$\text{Net assets} = \text{Stockholders' equity}$$

Another term sometimes used when referring to stockholders' equity is **net worth**. However, this term is misleading because it implies that the net assets are "worth" the amount reported on the balance sheet as stockholders' equity. *Financial statements prepared in accordance with generally accepted accounting principles do not purport to show the current market value of the entity's assets, except in a few restricted cases.*

What Does It Mean?
Answers on page 66

2. What does it mean to refer to a balance sheet for the year ended August 31, 2023?

3. What does it mean when a balance sheet has been prepared for an organization?

Each of the individual assets and liabilities reported by Main Street Store Inc. warrants a brief explanation. Each account (*caption* in the financial statements) is discussed in more detail in later chapters. Your task at this point is to achieve a broad understanding of each account and to make sense of its classification as an asset or liability.

LO 2-4
Explain the meaning of each of the captions on the financial statements illustrated in this chapter.

Cash represents cash on hand and in the bank or banks used by Main Street Store Inc. If the firm had made any temporary cash investments to earn interest, these marketable securities probably would be shown as a separate asset because these funds are not as readily available as cash.

Accounts receivable represent amounts due from customers who have purchased merchandise on credit and who have agreed to pay within a specified period or when billed by Main Street Store Inc.

Merchandise inventory represents the cost to Main Street Store Inc. of the merchandise that it has acquired but not yet sold.

Equipment represents the cost to Main Street Store Inc. of the display cases, racks, shelving, and other store equipment purchased and installed in the rented building in which it operates. The building is not shown as an asset because Main Street Store Inc. does not own it.

Accumulated depreciation represents the portion of the cost of the equipment that is estimated to have been used up in the process of operating the business. Note that one-tenth ($4,000/$40,000) of the cost of the equipment has been depreciated. From this relationship, one might assume that the equipment is estimated to have a useful life of 10 years because this is the balance sheet at the end of the firm's first year of operations. **Depreciation** in accounting is the process of spreading the cost of an asset over its useful life to the entity—it is *not* an attempt to recognize the economic loss in value of an asset because of its age or use.

Accounts payable represent amounts owed to suppliers of merchandise inventory that was purchased on credit and will be paid within a specific period of time.

Other **accrued liabilities** represent amounts owed to various creditors, including any wages owed to employees for services provided to Main Street Store Inc. through August 31, 2023, the balance sheet date.

Short-term debt represents amounts borrowed, probably from banks, that will be repaid within one year of the balance sheet date.

Long-term debt represents amounts borrowed from banks or others that will not be repaid within one year from the balance sheet date.

Stockholders' equity, shown as a single amount in Exhibit 2-1, is explained in more detail later in this chapter in the discussion of the statement of changes in stockholders' equity.

Notice that in Exhibit 2-1 some assets and liabilities are classified as "current". **Current assets** are cash and other assets that are likely to be converted into cash or used to benefit the entity within one year, and **current liabilities** are those liabilities that are likely to be paid with cash within one year of the balance sheet date. In this example, it is expected that the accounts receivable from the customers of Main Street Store Inc. will be collected within a year and that the merchandise inventory will be sold within a year of the balance sheet date. This time-frame classification is important and, as explained later, is used in assessing the entity's ability to pay its obligations when they come due.

To summarize, the balance sheet is a listing of the entity's assets, liabilities, and stockholders' equity. A balance sheet can be prepared as of any date but is most frequently prepared as of the end of a fiscal reporting period (e.g., month-end or year-end). The balance sheet as of the end of one period is the balance sheet as of the beginning of the next period. This can be illustrated on a timeline as follows:

8/31/22	Fiscal 2023	8/31/23
Balance sheet	Income statement for the year	Balance sheet
	Revenues	
	− Expenses	
A = L + SE	Net income	A = L + SE

On the timeline, Fiscal 2023 refers to the 12 months during which the entity carried out its economic activities.

Income Statement The principal purpose of the **income statement**, or **statement of earnings**, or **profit and loss statement**, or **statement of operations**, is to answer the question "Did the entity operate at a **profit** for the period of time under consideration?" The question is answered by first reporting **revenues** from the entity's operating activities (such as selling merchandise) and then subtracting the **expenses** incurred in generating those revenues and operating the entity. **Gains** and **losses** are also reported on the income statement. Gains and losses result from nonoperating activities, rather than from the day-to-day operating activities that generate revenues and expenses. The income statement reports results for *a period of time,* in contrast to the balance sheet focus on a single date. In this sense, the income statement is more like a movie than a snapshot; it depicts the results of activities that have occurred during a period of time.

The income statement for Main Street Store, Inc., for the year ended August 31, 2023, is presented in Exhibit 2-2. Notice that the statement starts with **net sales** (which are revenues) and that the various expenses are subtracted to arrive at **net income** in total and per share of common stock outstanding. Net income is the profit for the period; if expenses exceed net sales, a net loss results. The reasons for reporting earnings per share of common stock outstanding, and the calculation of this amount, are explained in Chapter 9.

Exhibit 2-2
Income Statement

MAIN STREET STORE INC. Income Statement For the Year Ended August 31, 2023	
Net sales	$1,200,000
Cost of goods sold	850,000
Gross profit	$ 350,000
Selling, general, and administrative expenses	311,000
Income from operations	$ 39,000
Interest expense	9,000
Income before taxes	$ 30,000
Income taxes	12,000
Net income	$ 18,000
Earnings per share of common stock outstanding	$ 1.80

Now look at the individual captions on the income statement. Each warrants a brief explanation, which will be expanded in subsequent chapters. Your task at this point is to make sense of how each item influences the determination of net income.

Net sales represent the amount of sales of merchandise to customers, less the amount of sales originally recorded but canceled because the merchandise was subsequently returned by customers for various reasons (wrong size, spouse didn't want it, and so on). The sales amount is frequently called *sales revenue,* or just *revenue.* Revenue results from selling a product or providing a service to a customer.

Cost of goods sold represents the total cost of merchandise removed from inventory and delivered to customers as a result of sales. This is shown as a separate expense because of its significance and because of the desire to show gross profit as a separate subtotal on the income statement. Frequently used synonyms are *cost of sales* and *cost of products sold.*

Gross profit is the difference between net sales and cost of goods sold and represents the seller's maximum amount of "cushion" from which all other expenses of operating the business must be met before it is possible to have net income. Gross profit (sometimes referred to as *gross margin*) is shown as a separate subtotal because it is significant to both management and nonmanagement readers of the income statement. The uses made of this amount will be explained in subsequent chapters.

Selling, general, and administrative expenses represent the operating expenses of the entity. In some income statements, these expenses will not be lumped together as in Exhibit 2-2 but will be reported separately for each of several operating expense categories, such as wages, advertising, and depreciation.

Income from operations represents one of the most important measures of the firm's activities. Income from operations (or *operating income* or *earnings from operations*) can be related to the assets available to the firm to obtain a useful measure of management's performance. A method of doing this is explained in Chapter 3.

Interest expense represents the cost of using borrowed funds. This item is reported separately because it is a function of how assets are financed, not how assets are used.

Income taxes are shown after all the other income statement items have been reported, because income taxes (often captioned as *income tax expense* or *provision for income taxes*) are a function of the firm's income before taxes.

Earnings per share of common stock outstanding is reported as a separate item at the bottom of the income statement because of its significance in evaluating the market value of a share of common stock. This measure, which is often referred to simply as *EPS,* is explained in more detail in Chapter 9.

To review, the income statement summarizes the entity's income- (or loss-) producing activities *for a period of time.* Transactions that affect the income statement also affect the balance sheet. For example, a sale made for cash increases sales revenue on the income statement and increases cash, an asset on the balance sheet. Likewise, wages earned by employees during the last week of the current year to be paid early in the next year are an expense of the current year. These wages will be deducted from revenues in the income statement and are considered a liability reported on the balance sheet at the end of the year. Thus, the income statement is a link between the balance sheets at the beginning and end of the year. How this link is made is explained in the next section, which describes the statement of changes in stockholders' equity. The timeline presented earlier can be expanded as follows:

8/31/22	Fiscal 2023	8/31/23
Balance sheet	Income statement for the year	Balance sheet
	Revenues	
	– Expenses	
A = L + SE	Net income	A = L + SE

Statement of Changes in Stockholders' Equity The **statement of changes in stockholders' equity** (sometimes called the *statement of changes in owners' equity*), or **statement of changes in capital stock**, or **statement of changes in retained earnings**, or **statement of stockholders' equity,** or **statement of equity,** like the income statement, has a *period of time* orientation. This statement shows the detail of stockholders' equity and explains the changes that occurred in the components of stockholders' equity during the year.

Exhibit 2-3 illustrates this statement for Main Street Store Inc. for the year ended August 31, 2023. Remember that these are the results of Main Street Store's first year of

Exhibit 2-3

Statement of Changes in Stockholders' Equity

MAIN STREET STORE INC.
Statement of Changes in Stockholders' Equity
For the Year Ended August 31, 2023

Paid-In Capital:	
Beginning balance	$ –0–
Common stock, par value, $10; 50,000 shares authorized, 10,000 shares issued and outstanding	100,000
Additional paid-in capital	90,000
Balance, August 31, 2023	$190,000
Retained Earnings:	
Beginning balance	$ –0–
Net income for the year	18,000
Less: Cash dividends of $.50 per share	(5,000)
Balance, August 31, 2023	$ 13,000
Total stockholders' equity	$203,000

Business in
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Par Value

Par value is a relic that has, for all practical purposes, lost its significance. The par value of common stock is an arbitrary value assigned when the corporation is organized. Par value bears no relationship to the fair market value of a share of stock (except that a corporation may not issue its stock for less than par value). Many firms issue stock with a par value of a nominal amount, such as $1. Campbell Soup Company's capital stock has a par value of $0.0375 per share. (See the Consolidated Balance Sheets in the appendix.) Because of investor confusion about the significance of par value, most states now permit corporations to issue no-par-value stock. Some state laws permit a firm to assign a stated value to its no-par-value stock, in which case the stated value operates as a par value.

operations, so the beginning-of-the-year balances are zero. On subsequent years' statements, the beginning-of-the-year amount is the ending balance from the prior year.

Notice in Exhibit 2-3 that stockholders' equity is made up of two principal components: **paid-in capital** and **retained earnings**. These items are briefly explained here and are discussed in more detail in Chapter 8.

Paid-in capital represents the total amount invested in the entity by the owners—in this case, the stockholders. When the stock issued to the owners has a **par value** (see Business in Practice—Par Value), there will usually be two categories of paid-in capital: common stock and additional paid-in capital.

Common stock reflects the number of shares authorized by the corporation's charter, the number of shares that have been issued to stockholders, and the number of shares that are held by the stockholders (referred to as shares outstanding). When the common stock has a par value or stated value, the amount shown for common stock in the financial statements will always be the par value or stated value multiplied by the number of shares issued. If the common stock does not have a par value or stated value, the amount shown for common stock in the financial statements will be the total amount invested by the stockholders.

Additional paid-in capital is the difference between the total amount invested by the stockholders and the par value or stated value of the stock. (If no-par-value stock without a stated value is issued, there won't be any additional paid-in capital because the total amount paid in, or invested, by the stockholders will be shown as common stock.)

Retained earnings is the second principal category of stockholders' equity, and it represents the cumulative net income of the entity that has been retained for use in the business. **Dividends** are distributions of earnings that have been made to the stockholders, so these reduce retained earnings. If retained earnings has a negative balance because cumulative losses and dividends have exceeded cumulative net income, this part of stockholders' equity is referred to as an *accumulated deficit,* or simply *deficit.*

Note that net income of $18,000, as reported in Exhibit 2-2, is added to the beginning retained earnings of $0 in Exhibit 2-3, and cash dividends paid for the year of $5,000 are subtracted in arriving at the $13,000 ending retained earnings balance. The retained earnings section of the statement of changes in stockholders' equity is where the link (known as *articulation*) between the balance sheet and income statement is made. The timeline model is thus expanded and modified as follows: