The Role of Accountants and Accounting Information

chapter # 15

Copyright © 2015 Pearson Education, Inc.

Introduction

- **In this chapter we**
  - explore the fundamental concepts of accounting
  - apply them to familiar business situations
  - discuss how you as an employee, taxpayer, or owner—will be able to participate when the conversation turns to the financial matters that constitute so great a part of a firm's daily operations.

Copyright © 2015 Pearson Education, Inc.

learning objectives

1. ***Explain*** *the role of accountants and distinguish between the kinds of work done by public accountants, private accountants, management accountants, and forensic accountants*
2. ***Explain*** *how the accounting equation is used*
3. ***Describe*** *the three basic financial statements and show how they reflect the activity and financial condition of a business*
4. ***Explain*** *the key standards and principles for reporting financial statements.*

Copyright © 2015 Pearson Education, Inc.

learning objectives

5. ***Describe*** *how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business*
6. ***Discuss*** *the role of ethics in accounting*
7. ***Describe*** *the purpose of the International Accounting Standards Board and explain why it exists.*

Copyright © 2015 Pearson Education, Inc.

What Is Accounting, and Who Uses Accounting Information?

- **Accounting**
  - comprehensive system for collecting, analyzing, and communicating financial information
- **Bookkeeping**
  - recording of accounting transactions

Copyright © 2015 Pearson Education, Inc.

What Is Accounting, and Who Uses Accounting Information? (cont.)

- **Accounting Information System (AIS)**
  - organized procedure for identifying, measuring, recording, and retaining financial information for use in accounting statements and management reports

Copyright © 2015 Pearson Education, Inc.

What Is Accounting, and Who Uses Accounting Information? (cont.)

- ***Business managers*** use it to develop goals and plans, set budgets, and evaluate future prospects.
- ***Employees and unions*** use it to plan for and receive compensation benefits.
- ***Investors and creditors*** use it to estimate returns to stockholders, determine growth prospects, and decide whether a firm is a good credit risk.

Copyright © 2015 Pearson Education, Inc.

What Is Accounting, and Who Uses Accounting Information? (cont.)

- ***Tax authorities*** use it to plan for tax inflows, determine the tax liabilities of individuals and businesses, and ensure that correct amounts are paid on time.
- ***Government regulatory agencies*** rely on it to fulfill their duties toward the public.

Copyright © 2015 Pearson Education, Inc.

Who Are Accountants and What Do They Do?

- **Controller**
  - person who manages all of a firm's accounting activities (chief accounting officer)
- **Certified Public Accountant (CPA)**
  - Accountant licensed by the state and offering services to the public

Copyright © 2015 Pearson Education, Inc.

Financial versus Managerial Accounting

- **Financial Accounting**
  - field of accounting concerned with external users of a company's financial information
- **Managerial (Management) Accounting**
  - field of accounting that serves internal users of a company's financial information

Copyright © 2015 Pearson Education, Inc.

CPA Services

- **Audit**
  - systematic examination of a company's accounting system to determine whether its financial reports reliably represent its operations
- **Generally Accepted Accounting Principles (GAAP)**
  - accounting guidelines that govern the content and form of financial reports

Copyright © 2015 Pearson Education, Inc.

CPA Services (cont.)

- **Tax Services**
  - assistance provided by CPAs for tax preparation and tax planning
- **Management Advisory Services**
  - assistance provided by CPA firms in areas such as financial planning, information systems design, and other areas of concern for client firms
- **Core Competencies For Accounting**
  - the combination of skills, technology, and knowledge that will be necessary for the future CPA

Copyright © 2015 Pearson Education, Inc.

Emerging Competencies for Success in Accounting

table 15.1 Emerging Competencies for Success in Accounting

Skills in Strategic Thinking and Critical Problem Solving	The accountant can combine data with reasoning and professional knowledge to recognize and help solve critical problems for better strategic action.
Communications, Interpersonal Skills, and Effective Leadership	The accountant can communicate effectively in various business situations using meaningful communications skills that provide interpersonal effectiveness and leadership.
Dedication to Meeting Customer Needs	The accountant surpasses the competition in understanding each client's unique needs, in meeting those needs, and in visualizing the client's future needs.
Ability to Integrate Diverse Information	The accountant can combine financial and other kinds of information to gain new meaning that provides clients with useful insights and understanding for solving problems.
Proficiency with Information Technology	The accountant can use information technology (IT) in performing services for clients and can identify IT applications that the client can adopt for added value to the business.

Source: Based on "The CPA Vision Project and Beyond," *The American Institute of Certified Public Accountants,* at http://www.aicpa.org/RESEARCH/CPAHORIZONS2025/CPAVISIONPROJECT/Pages/CPAVisionProject.aspx, accessed on February 11, 2013.

Copyright © 2015 Pearson Education, Inc.

Private Accountants and Management Accountants

- **Private Accountant**
  - salaried accountant hired by a business to carry out its day-to-day financial activities
- **Management Accountant**
  - private accountant who provides financial services to support managers in various business activities within a firm
- **Certified Management Accountant (CMA)**
  - professional designation awarded by the institute of Management Accountants (IMA) in recognition of management accounting qualifications

Copyright © 2015 Pearson Education, Inc.

Forensic Accountants

- **Forensic Accounting**
  - the practice of accounting for legal purposes
- **Certified Fraud Examiner (CFE)**
  - professional designation administered by the Association of Certified Fraud Examiners in recognition of qualifications for a specialty area within forensic accounting

Copyright © 2015 Pearson Education, Inc.

Federal Restrictions on CPA Services and Financial Reporting: Sarbox

- **Sarbanes-Oxley Act of 2002**
  - **(Sarbox or Sox) –** enactment of federal regulations to restore public trust in accounting practices by imposing new requirements on financial activities in publicly traded corporations

Copyright © 2015 Pearson Education, Inc.

Selected Provisions of the Sarbanes-Oxley Act

table 15.2 Selected Provisions of the Sarbanes-Oxley Act[17]

- Creates a national Accounting Oversight Board that, among other activities, must establish the ethics standards used by CPA firms in preparing audits.
- Requires that auditors retain audit working papers for specified periods of time.
- Requires auditor rotation by prohibiting the same person from being the lead auditor for more than 5 consecutive years.
- Requires that the CEO and CFO certify that the company's financial statements are true, fair, and accurate.
- Prohibits corporations from extending personal loans to executives and directors.
- Requires that the audited company disclose whether it has adopted a code of ethics for its senior financial officers.
- Requires that the SEC regularly review each corporation's financial statements.
- Prevents employers from retaliating against research analysts who write negative reports.
- Imposes criminal penalties on auditors and clients for falsifying, destroying, altering, or concealing records (10 years in prison).
- Imposes a fine or imprisonment (up to 25 years) on any person who defrauds shareholders.
- Increases penalties for mail and wire fraud from 5 to 20 years in prison.
- Establishes criminal liability for failure of corporate officers to certify financial reports.

Copyright © 2015 Pearson Education, Inc.

The Accounting Equation

- **Accounting Equation**
  - Assets = Liabilities + Owners' Equity
  - used by accountants to balance data for the firm's financial transactions at various points in the year

Copyright © 2015 Pearson Education, Inc.

The Accounting Equation

- **Asset**
  - any economic resource expected to benefit a firm or an individual who owns it
- **Liability**
  - debt owed by a firm to an outside organization or individual
- **Owners' Equity**
  - amount of money that owners would receive if they sold all of a firm's assets and paid all of its liabilities

Copyright © 2015 Pearson Education, Inc.

Financial Statements

- **Financial Statement**
  - any of several types of reports summarizing a company's financial status to stakeholders and to aid in managerial decision making
  - balance sheet, income statement, statement of cash flows

Copyright © 2015 Pearson Education, Inc.

Balance Sheets

- **Balance Sheet**
  - financial statement that supplies detailed information about a firm's assets, liabilities, and owners' equity

Copyright © 2015 Pearson Education, Inc.

Google's Balance Sheet

Google, Inc.
Summary of Balance Sheet (condensed)
as of December 31, 2012
(in millions)

Assets	
Current assets:	
Cash	$14,778
Marketable securities	33,310
Other	12,366
Total current assets	**$60,454**
Fixed assets:	
Property and equipment, net	$11,854
Other	3,480
Total fixed assets	**$15,334**
Intangible assets:	
Intangible assets	$7,473
Goodwill	10,537
Total intangible assets	**$18,010**
Total assets	**$93,798**

Liabilities and Shareholders' Equity	
Current liabilities:	
Accounts payable	$10,893
Other	3,444
Total current liabilities	**$14,337**
Long-term liabilities:	
All long-term debts	$2,988
Other	4,758
Total long-term liabilities	**$7,746**
Total liabilities	**$22,083**
Shareholders' equity:	
Paid-in capital	$23,373
Retained earnings	48,342
Total shareholders' equity	**$71,715**
Total liabilities and shareholders' equity	**$93,798**

Google's balance sheet for year ended December 31, 2012. The balance sheet shows clearly that the firm's total assets are equal to its total liabilities and owners' equity.

Copyright © 2015 Pearson Education, Inc.

Balance Sheets

- **Current Asset**
  - asset that can or will be converted into cash within a year
- **Liquidity**
  - ease with which an asset can be converted into cash
- **Fixed Asset**
  - asset with long-term use or value, such as land, buildings, and equipment
- **Depreciation**
  - accounting method for distributing the cost of an asset over its useful life

Copyright © 2015 Pearson Education, Inc.

Balance Sheets (cont.)

- **Current Liability**
  - debt that must be paid within one year
- **Accounts Payable (Payables)**
  - current liability consisting of bills owed to suppliers
- **Long-Term Liability**
  - debt that is not due for at least one year
- **Retained Earnings**
  - earnings retained by a firm for its use rather than paid out as dividends

Copyright © 2015 Pearson Education, Inc.

Balance Sheets (cont.)

- **Intangible Asset**
  - nonphysical asset, such as a patent or trademark, that has economic value in the form of expected benefit
- **Goodwill**
  - amount paid for an existing business above the value of its other assets

Copyright © 2015 Pearson Education, Inc.

Income Statements

- **Income Statement (Profit-and-Loss Statement)**
  - financial statement listing a firm's annual revenues and expenses so that a bottom line shows annual profit or loss
  - revenues, cost of revenues, operating expenses, and net income

$$\text{Profit (or Loss)} = \text{Revenues} - \text{Expenses}$$

Copyright © 2015 Pearson Education, Inc.

Google's Income Statement

Google, Inc.
Summary of Income Statement (condensed)
as of December 31, 2012
(in millions)

Revenues (gross sales)		**$50,175**
Cost of revenues	**20,634**	
Gross profit		**$29,541**
Operating expenses:		
Research Development	6,793	
Selling, Administrative and General	9,988	
Total operating expenses		**$16,781**
Operating income (before taxes)		12,760
Income taxes*		2,023
Net income		**$10,737**

*approximated

Google's income statement for year ended December 31, 2012. The final entry on the income statement, the bottom line, reports the firm's profit or loss.

FIGURE 15.2 Google's Income Statement

Copyright © 2015 Pearson Education, Inc.

Income Statements

- **Revenues**
  - funds that flow into a business from the sale of goods or services
- **Cost of Goods Sold**
  - costs of obtaining materials for making the products sold by a firm during the year
- **Operating Expenses**
  - costs, other than the cost of revenues, incurred in producing a good or service

Copyright © 2015 Pearson Education, Inc.

Income Statements (cont.)

- **Gross Profit**
  - preliminary, quick-to-calculate profit figure calculated from the firm's revenues minus its cost of revenues (the direct costs of getting the revenues)
- **Operating Income**
  - gross profit minus operating expenses
- **Net Income (Net Profit, Net Earnings)**
  - gross profit minus operating expenses and income taxes

Copyright © 2015 Pearson Education, Inc.

Statements of Cash Flows

- **Statement of Cash Flows**
  - financial statement describing a firm's yearly cash receipts and cash payments

Copyright © 2015 Pearson Education, Inc.

Google's Statement of Cash Flows

Google, Inc.
Summary of Statement of Cash Flows (condensed)
as of December 31, 2012
Increase (Decrease) in Cash
(in millions)

Net cash provided by operating activities		**$16,619.**
Cash from investments:		
Purchases of property, equipment, and investments	(48,281.)	
Cash inflows from investment activities	35,225.	
Net cash used in investing activities		**(13,056.)**
Cash flows from financing activities:		
Repayment of debt	(14,781.)	
Borrowings	16,109.	
Other	(99.)	
Net cash provided by financing activities		**1,229.**
Net increase in cash		4,792.
Cash at beginning of year		9,983.
Cash at end of year		**$14,775.**

Google's statement of cash flows for year ended December 31, 2012. The final entry shows year-end cash position resulting from operating activities, investing activities, and financing activities.

FIGURE 15.3 Google's Statement of Cash Flows

Copyright © 2015 Pearson Education, Inc.

The Budget: An Internal Financial Statement

- **Budget**
  - detailed statement of estimated receipts and expenditures for a future period of time

Copyright © 2015 Pearson Education, Inc.

Perfect Posters' Sales Budget

Perfect Posters, Inc.
555 RIVERVIEW, CHICAGO, IL 60606

Perfect Posters, Inc.
Sales Budget
First Quarter, 2014

	January	February	March	Quarter
Budgeted sales (units)	7,500	6,000	6,500	20,000
Budgeted selling price per unit	$3.50	$3.50	$3.50	$3.50
Budgeted sales revenue	**$26,250**	**$21,000**	**$22,750**	**$70,000**
Expected cash receipts:				
From December sales	$26,210			$26,210
From January sales	17,500	$8,750		26,250
From February sales		14,000	$7,000	21,000
From March sales			15,200	15,200
Total cash receipts:	**$43,710**	**$22,750**	**$22,200**	**$88,660**

FIGURE 15.4 Perfect Posters' Sales Budget

Copyright © 2015 Pearson Education, Inc.

Reporting Standards and Practices

- **Revenue Recognition**
  - formal recording and reporting of revenues at the appropriate time
- **Full Disclosure**
  - guideline that financial statements should not include just numbers but should also furnish management's interpretations and explanations of those numbers

Copyright © 2015 Pearson Education, Inc.

Analyzing Financial Statements

- **Solvency Ratio**
  - financial ratio, either short- or long-term, for estimating the borrower's ability to repay debt
- **Profitability Ratio**
  - financial ratio for measuring a firm's potential earnings
- **Activity Ratio**
  - financial ratio for evaluating management's efficiency in using a firm's assets

Copyright © 2015 Pearson Education, Inc.

Solvency Ratios: Borrower's Ability to Repay Debt

- **Short-Term Solvency Ratio**
  - financial ratio for measuring a company's ability to pay immediate debts
- **Current Ratio**
  - financial ratio for measuring a company's ability to pay current debts out of current assets

Copyright © 2015 Pearson Education, Inc.

Long-Term Solvency

- **Debt**
  - company's total liabilities
- **Leverage**
  - ability to finance an investment through borrowed funds

Copyright © 2015 Pearson Education, Inc.

Profitability Ratios: Earnings Power for Owners

- **Earnings Per Share**
  - profitability ratio measuring the net profit that the company earns for each share of outstanding stock

Copyright © 2015 Pearson Education, Inc.

Profitability Ratios: Earnings Power for Owners (cont.)

- **Earnings Per Share**
  - profitability ratio measuring the net profit that the company earns for each share of outstanding stock

Copyright © 2015 Pearson Education, Inc.

AICPA's Code of Professional Conduct

- **Code of Professional Conduct**
  - code of ethics for CPAs as maintained and enforced by the AICPA

Copyright © 2015 Pearson Education, Inc.

Highlights from the Code of Ethics for CPAs

table 15.3 Highlights from the Code of Ethics for CPAs

By voluntarily accepting Certified Public Accountant membership, the accountant also accepts self-enforced obligations, listed here, beyond written regulations and laws.

Responsibilities as a Professional	The CPA should exercise their duties with a high level of morality and in a manner that is sensitive to bringing credit to their profession.
Serving the Public Interest	The CPA should demonstrate commitment to the profession by respecting and maintaining the public trust and serving the public honorably.
Maintaining Integrity	The CPA should perform all professional activities with highest regards for integrity, including sincerity and honesty, so as to promote the public's confidence in the profession.
Being Objective and Independent	The CPA should avoid conflicts of interest, and the appearance of conflicts of interest, in performing their professional responsibilities. They should be independent from clients when certifying to the public that the client's statements are true and genuine.
Maintaining Technical and Ethical Standards through Due Care	The CPA should exercise "due care," through professional improvement, abiding by ethical standards, updating personal competence through continuing accounting education, and improving the quality of services.
Professional Conduct in Providing Services	The CPA in public practice should abide by the meaning and intent of the Code of Professional Conduct when deciding on the kinds of services and the range of actions to be supplied competently and diligently for clients.

Source: Based on "Code of Professional Conduct," *AICPA*, at www.aicpa.org/Research/Standards/CodeofConduct/Pages/sec50.aspx, accessed on February 17, 2013.

Copyright © 2015 Pearson Education, Inc.

Examples of Unethical and Illegal Accounting Actions

table 15.4 Examples of Unethical and Illegal Accounting Actions[28]

Corporation	Accounting Violation
AOL Time Warner	America Online (AOL) inflated ad revenues to keep stock prices high before and after merging with Time Warner.
Freddie Mac	This U.S. government corporation fraudulently misstated $5 billion in earnings.
HCA, Columbia/HCA	Healthcare association and hospital defrauded Medicare, Medicaid, and TRICARE through false cost claims and unlawful billings (paid $1.7 billion in civil penalties, damages, criminal fines, and penalties).
Tyco	CEO Dennis Kozlowski illegally used company funds to buy expensive art for personal possession (he received an 8- to 25-year prison sentence).
Waste Management	Overstated income in financial statements (false and misleading reports) by improperly calculating depreciation and salvage value for equipment.
WorldCom	Hid $3.8 billion in expenses to show an inflated (false) profit instead of loss in an annual income statement.

Copyright © 2015 Pearson Education, Inc.

Internationalizing Accounting

- **International Accounting Standards Board (IASB)**
  - organization responsible for developing a set of global accounting standards and for gaining implementation of those standards

Copyright © 2015 Pearson Education, Inc.

Applying What You've Learned

1. **Explain** the role of accountants and distinguish between the kinds of work done by public accountants, private accountants, management accountants, and forensic accountants
2. **Explain** how the accounting equation is used
3. **Describe** the three basic financial statements and show how they reflect the activity and financial condition of a business
4. **Explain** the key standards and principles for reporting financial statements.

Copyright © 2015 Pearson Education, Inc.

Applying What You've Learned

5. **Describe** how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business
6. **Discuss** the role of ethics in accounting
7. **Describe** the purpose of the International Accounting Standards Board and explain why it exists.

Copyright © 2015 Pearson Education, Inc.

This work is protected by United States copyright laws and is provided solely for the use of instructors in teaching their courses and assessing student learning. Dissemination or sale of any part of this work (including on the World Wide Web) will destroy the integrity of the work and is not permitted. The work and materials from it should never be made available to students except by instructors using the accompanying text in their classes. All recipients of this work are expected to abide by these restrictions and to honor the intended pedagogical purposes and the needs of other instructors who rely on these materials.