14 The Role of Accountants and Accounting Information

CSI: Wall Street

In the aftermath of a flurry of financial scandals, many companies are showing an urgent interest in the field of forensic accounting: the use of accounting for legal purposes. The expansion of the forensic accounting field—the Association of Certified Fraud Examiners (ACFE) has experienced a surging membership, reaching 55,000 professionals in 2011—is due to increased vigilance against various kinds of financial scams, including a strong desire on the part of companies to protect themselves from accounting fraud.

Fraud examiners typically begin an investigation of a company by interviewing high-level executives. Team members pursue tips from employees or outsiders, then comb through e-mails, searching for suspicious words and phrases. The combination of interviews and e-mails may lead investigators to specific accounting files or ledger entries. According to Al Vondra, a Certified Fraud Examiner at PricewaterhouseCoopers, some of the most common fraudulent practices involve hiding revenues and expenses under phony categories such as "Total Noncurrent Assets" or "Other Current Liabilities." At India's Satyam Computer Services Ltd., for example, founder and former CEO Ramalinga Raju was arrested after admitting he falsified accounts, thus deceiving investors for years. The government's Serious Fraud Investigation Office is searching to identify collaborators who falsely reported more than $1 billion in cash and assets that didn't exist at India's fourth largest software company.[1]

After reading this chapter, you should be able to:

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.**

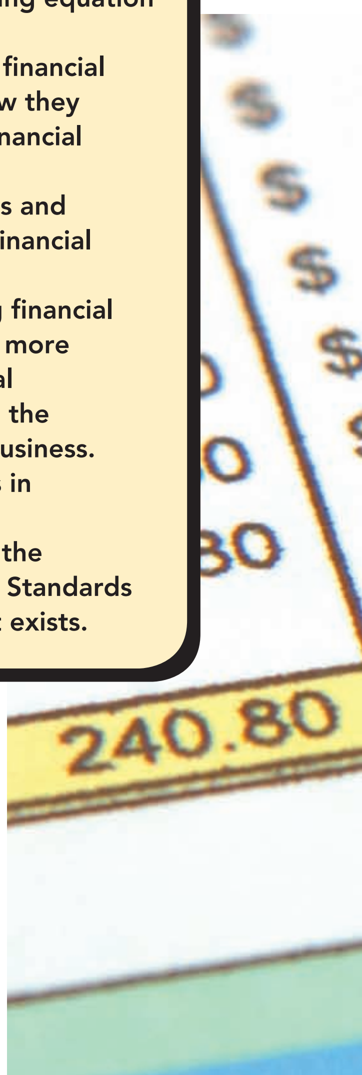
3 **Describe the three basic financial statements and show how they reflect the activity and financial condition of a business.**

4 **Explain the key standards and principles for reporting financial statements.**

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.**



Although accounting scandals have always existed, they spike upward in economic recessions. Data from the ACFE indicate that corporate fraud cases began increasing significantly early in the recent recession, and worldwide fraud losses reached $2.9 trillion in 2009. Fraud-related reports and whistle-blowing at U.S. firms also jumped dramatically in 2009. ACFE members believe the increase stems from heavier financial pressures: When employees feel less secure, they may falsify data to show better performance, or they may take greater risks that need to be covered up to show financial success. Forensic accounting professor Tommie Singleton states, "The cases of fraud will only climb as the country sinks into recession, and with that so will the demand for highly skilled, specialized forensic accountants to help prevent, detect and prosecute those looking to cheat the system."[2]

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WHAT'S IN IT FOR ME?

For most of us, the words and ideas in accounting can seem like a foreign language. As we have seen, the specialized terminology can be used to mask fraud and corruption. However, it's also a necessary tool that allows professionals in every industry to analyze growth, understand risk, and communicate complex ideas about a firm's financial health. This chapter will cover the fundamental concepts of accounting and apply them to familiar business situations. By grasping the basic accounting vocabulary you 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.

MyBizLab Where you see MyBizLab in this chapter, go to **www.mybizlab.com** for additional activities on the topic being discussed.

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What Is Accounting, and Who Uses Accounting Information?

Accounting is a comprehensive system for collecting, analyzing, and communicating financial information to a firm's owners and employees, to the public, and to various regulatory agencies. To perform these functions, accountants keep records of taxes paid, income received, and expenses incurred—a process called **bookkeeping**—and they assess the effects of these transactions on business activities. By sorting and analyzing such transactions, accountants can determine how well a business is being managed and how financially strong it is.

Because businesses engage in thousands of transactions, ensuring consistent, dependable financial information is mandatory. This is the job of the **accounting information system (AIS)**—an organized procedure for identifying, measuring, recording, and retaining financial information so that it can be used in accounting statements and management reports. The system includes all of the people, reports, computers, procedures, and resources that are needed to compile financial transactions.[3]

Users of accounting information are numerous:

- *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 and such benefits as health care, vacation time, and retirement pay.
- *Investors and creditors* use it to estimate returns to stockholders, determine growth prospects, and decide whether a firm is a good credit risk.
- *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. The Securities and Exchange Commission (SEC), for example, requires firms to file financial disclosures so that potential investors have valid information about their financial status.

1 Explain the role of accountants and distinguish between the kinds of work done by public accountants, private accountants, management accountants, and forensic accountants.

Who Are Accountants and What Do They Do?

The **controller,** or chief accounting officer, manages a firm's accounting activities by ensuring that the AIS provides the reports and statements needed for planning, decision making, and other management activities. This range of activities requires different types of accounting specialists. In this section, we begin by distinguishing between the two main fields of accounting: *financial* and *managerial*. Then, we discuss the different functions and activities of *certified public accountants*, *private accountants*, *management accountants*, and *forensic accountants*.

Gain hands-on experience through an interactive, real-world scenario. This chapter's simulation, entitled OBM and Financial Statements, is located at **www.mybizlab.com.**

Financial versus Managerial Accounting

In any company, the two fields of accounting—financial and managerial—can be distinguished by the users they serve: those outside the company and those within.[4]

Financial Accounting A firm's **financial accounting** system is concerned with external information users: consumer groups, unions, stockholders, suppliers, creditors, and government agencies. It prepares reports such as income statements and balance sheets that focus on the activities of the company as a whole rather than on individual departments or divisions.[5]

Managerial Accounting **Managerial (management) accounting** serves internal users. Managers at all levels need information to make departmental decisions, monitor projects, and plan future activities. Other employees also need accounting information. Engineers must know certain costs, for example, before making product or operations improvements, purchasing agents use information on materials costs to negotiate terms with suppliers, and to set performance goals, salespeople need past sales data organized by geographic region.

Certified Public Accountants

Public accountants offer accounting services to the public and are distinguished by their independence from the clients they serve. That is to say, they typically work for an accounting firm providing services for outside client firms in which the public accountant has no vested interest, thus avoiding any potential biases in conducting their professional services. Among public accountants, **certified public accountants (CPAs)** are licensed by a state after passing an exam prepared by the American Institute of Certified Public Accountants (AICPA). Preparation for certification begins with majoring in a college program studying the theory, practices, and legal aspects of accounting. In addition to the CPA exam, certification requires two years of practice in an accounting firm and extensive experience in auditing. Once certified, the CPA can perform services beyond those allowed by non-certified public accountants.[6] Whereas some CPAs work as individual practitioners, many form or join existing partnerships or professional corporations.

CPA Services Virtually all CPA firms, whether large or small, provide auditing, tax, and management services. Larger firms such as Deloitte Touche Tohmatsu and Ernst & Young earn much of their revenue from auditing services, though consulting (management advisory) services constitute a major growth area. Smaller firms earn most of their income from tax and management services.

Auditing An **audit** examines a company's AIS to determine whether financial reports reliably represent its operations.[7] Organizations must provide audit reports when applying for loans, selling stock, or when going through a major restructuring. Independent auditors who do not work for the company must ensure that clients' accounting systems follow **generally accepted accounting principles (GAAP),** which are formulated by the Financial Accounting Standards Board (FASB) of the AICPA and govern the content and form of financial reports.[8] The auditing of a firm's financial statements is one of the services that can be performed only by a CPA. The Securities and Exchange Commission (SEC) is the U.S. government agency that legally enforces accounting and auditing rules and procedures. Ultimately, the auditor will certify whether the client's reports comply with GAAP.

Ron Sachs-CNP-PHOTOlink.net/Newscom

Sometimes, companies ignore GAAP and accountants fail to disclose violations. Richard Causey (right) was Chief Account Executive at now-bankrupt Enron, and was responsible for the firm's public accounting statements. Pleading guilty to securities fraud, he was sentenced to seven years in prison and forfeited $1.25 million.

Accounting comprehensive system for collecting, analyzing, and communicating financial information

Bookkeeping recording of accounting transactions

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

Controller person who manages all of a firm's accounting activities (chief accounting officer)

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

Certified Public Accountant (CPA) accountant licensed by the state and offering services to the public

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

Tax Services **Tax services** include assistance not only with tax-return preparation but also with tax planning. A CPA's advice can help a business structure (or restructure) operations and investments and perhaps save millions of dollars in taxes. Staying abreast of tax-law changes is no simple matter. Some critics charge that tax changes have become a full-time vocation among some state and federal legislators who add increasingly complicated laws and technical corrections on taxation each year.

Management Advisory Services As consultants, accounting firms provide **management advisory services** ranging from personal financial planning to planning corporate mergers. Other services include production scheduling, information systems studies, AIS design, and even executive recruitment. The staffs of the largest CPA firms include engineers, architects, mathematicians, and psychologists, all of whom are available for consulting.

Noncertified Public Accountants Many accountants don't take the CPA exam; others work in the field while getting ready for it or while meeting requirements for state certification. Many small businesses, individuals, and even larger firms rely on these noncertified public accountants for income-tax preparation, payroll accounting, and financial-planning services so long as they abide by local and state laws. Noncertified accountants often put together financial statements that are used in the firm for internal purposes, based on information provided by management. These statements may include a notification that auditing methods were not used in their preparation.

The CPA Vision Project The recent talent shortage in accounting has led the profession to rethink its culture and lifestyle.[9] With grassroots participation from CPAs, educators, and industry leaders, the AICPA, through its CPA Vision Project, is redefining the role of the accountant for today's world economy. The Vision Project identifies a unique combination of skills, technology, and knowledge—called **core competencies for accounting**—that will be necessary for the future CPA. As Table 14.1 shows, those skills—which include communication, critical thinking, and leadership—go far beyond the ability to "crunch numbers." They include certain communications skills, along with skills in critical thinking and leadership. Indeed, the CPA Vision Project foresees CPAs who combine specialty skills with a broad-based orientation in order to communicate more effectively with people in a wide range of business activities.

TABLE 14.1 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," *American Institute of Certified Public Accountants*, at http://www.aicpa.org/RESEARCH/CPAHORIZONS2025/CPAVISIONPROJECT/Pages/CPAVisionProject.aspx, accessed on March 8, 2011.

Private Accountants and Management Accountants

To ensure integrity in reporting, CPAs are always independent of the firms they audit. However, many businesses also hire their own salaried employees—**private accountants**—to perform day-to-day activities.

Private accountants perform numerous jobs. An internal auditor at ConocoPhillips might fly to the North Sea to confirm the accuracy of oil-flow meters on offshore petroleum drilling platforms. A supervisor responsible for $2 billion in monthly payouts to vendors and employees may never leave the executive suite, with duties such as hiring and training, assigning projects, and evaluating performance of accounting personnel. Large businesses employ specialized accountants in such areas as budgeting, financial planning, internal auditing, payroll, and taxation. In small businesses, a single person may handle all accounting tasks.

While private accountants may be either CPAs or noncertified accountants, most are **management accountants** who provide services to support managers in various activities (marketing, production, engineering, and so forth). Many hold the **certified management accountant (CMA)** designation, awarded by the Institute of Management Accountants (IMA), recognizing qualifications of professionals who have passed IMA's experience and examination requirements. With more than 60,000 worldwide members, IMA is dedicated to supporting accounting professionals to create quality internal controls and financial practices in their companies.

Forensic Accountants

The fastest growing area in accounting is **forensic accounting**—the use of accounting for legal purposes.[10] Sometimes known as "the private eyes of the corporate culture," forensic accountants must be good detectives. They look behind the corporate façade instead of accepting financial records at face value. In combining investigative skills with accounting, auditing, and the instincts of a bloodhound, they assist in the investigation of business and financial issues that may have application to a court of law. Forensic accountants may be called upon—by law enforcement agencies, insurance companies, law firms, and business firms—for both investigative accounting and litigation support in crimes against companies, crimes by companies, and civil disagreements. They may conduct criminal investigations of Internet scams and misuse of government funds. Civil cases often require investigating and quantifying claims of personal injury loss due to negligence and analyzing financial issues in matrimonial disputes. Forensic accountants also assist business firms in tracing and recovering lost assets from employee business fraud or theft.

Investigative Accounting

A forensic accountant may be asked to investigate a trail of financial transactions behind a suspected crime, as in a money-laundering scheme or an investment swindle. Try your hand, for example, at "Catch Me If You Can," the popular interactive forensic accounting game sponsored by the AICPA (at **www.StartHereGoPlaces.com).** The forensic accountant, being familiar with the legal concepts and procedures of the case, identifies and analyzes pertinent financial evidence—documents, bank accounts, phone calls, computer records, and people—and presents accounting conclusions and their legal implications. They develop reports, exhibits, and documents to communicate their findings.

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

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 in recognition of management accounting qualifications

Forensic Accounting the practice of accounting for legal purposes

Litigation Support Forensic accountants assist in the application of accounting evidence for judicial proceedings by preparing and preserving evidence for these proceedings. They also assist by presenting visual aids to support trial evidence, by testifying as expert witnesses, and, especially, in determining economic damages in any case before the court. A divorce attorney, for example, may suspect that assets are being understated and request financial analysis by a forensic accountant. A movie producer may need help in determining damages for breach of contract by an actress who quits before the film is completed.

Certified Fraud Examiners A specific area within forensic accounting—the **Certified Fraud Examiner (CFE)** designation—is administered by the Association of Certified Fraud Examiners. The CFE's activities focus specifically on fraud-related issues: fraud detection, evaluating accounting systems for weaknesses and fraud risks, investigating white-collar crime on behalf of law enforcement agencies, evaluating internal organizational controls for fraud prevention, and expert witnessing. Many CFEs, like Al Vondra from our opening story, find employment in corporations seeking to prevent fraud from within. The CFE examination covers four areas:

1. *Criminology and ethics.* Includes theories of fraud prevention and ethical situations
2. *Financial transactions.* Examines types of fraudulent financial transactions incurred in accounting records
3. *Fraud investigation.* Pertains to tracing illicit transactions, evaluating deception, and interviewing and taking statements
4. *Legal elements of fraud.* Includes rules of evidence, criminal and civil law, and rights of the accused and accuser

Eligibility to take the exam includes both educational and experience requirements. While a minimum of a Bachelor's degree is required, it does not have to be in accounting or any other specific field of study. Candidates without a bachelor's degree, but with fraud-related professional experience, may substitute two years of experience for each year of academic study. Experience requirements for certification include at least two years in any of several fraud-related areas, such as auditing, criminology, fraud investigation, or law.

Federal Restrictions on CPA Services and Financial Reporting: Sarbox

The financial wrongdoings associated with firms such as ImClone Systems, Tyco, WorldCom, Enron, Arthur Andersen, and others have not gone unnoticed in legislative circles. Federal regulations, in particular the **Sarbanes-Oxley Act of 2002** (**Sarbox** or **SOX**), have been enacted to restore public trust in corporate accounting practices.

Sarbox restricts the kinds of nonaudit services that CPAs can provide. Under the Sarbox law, for example, a CPA firm can help design a client's financial information system, but not if it also does the client's auditing. Hypothetically, an unscrupulous accounting firm's audit might intentionally overlook a client's false financial statements if, in return, the client rewards the accounting firm with a contract for lucrative nonaccounting services, such as management consulting. This was a core allegation in the Enron-Arthur Andersen scandal. By prohibiting auditing and nonauditing services to the same client, Sarbox encourages audits that are independent and unbiased.

Sarbox Compliance Requirements Sarbox imposes new requirements on virtually every financial activity in publicly traded corporations, as well as severe criminal penalties for persons committing or concealing fraud or destroying financial records. CFOs and CEOs, for example, have to pledge that the company's finances are correct and must vouch for the methods and internal controls used to get those numbers. Companies have to provide a system that is safe for all employees—potential whistleblowers—to anonymously report unethical accounting practices and illegal activities without fear of retaliation. Table 14.2 provides brief descriptions of several of Sarbox's many provisions.

TABLE 14.2 Selected Provisions of the Sarbanes-Oxley Act[11]

- 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 five 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.

The Accounting Equation

2 Explain how the accounting equation is used.

All accountants rely on record keeping to enter and track transactions. Underlying all record-keeping procedures is the most basic tool of accounting—the **accounting equation:**

Assets = Liabilities + Owners' Equity

After each financial transaction (e.g., payments to suppliers, sales to customers, wages to employees), the accounting equation must be in balance. If it isn't, then an accounting error has occurred. To better understand the importance of this equation, we must understand the terms *assets*, *liabilities*, and *owners' equity*.

Alex Segre/Alamy

The inventory at this auto dealership is among the company's assets: The cars constitute an economic resource because the firm will benefit financially as it sells them.

Assets and Liabilities

An **asset** is any economic resource that is expected to benefit a firm or an individual who owns it. Assets include land, buildings, equipment, inventories, and payments due the company (accounts receivable). Google, the Internet search and information provider, for example, held assets amounting to $57.851 billion at year-end 2010.[12]

A **liability** is a debt that a firm owes to an outside party. The total of Google's liabilities—all the debt owed to others—was $11.610 billion at the end of 2010.

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

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

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

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 You may have heard of the *equity* that a homeowner has in a house—that is, the amount of money that could be made (or lost) by selling the house and paying off the mortgage. Similarly, **owners' equity** is the amount of money that owners would receive if they sold all of a company's assets and paid all of its liabilities. Google's financial reports for 2010 declared shareholders' equity of $46.241 billion. For the Google example, we see that the accounting equation is in balance, as it should be.

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$$
$$\$57.851 = \$11.610 + \$46.241 \text{ billion}$$

We can rewrite the equation to highlight how owners' equity relates to assets and liabilities.

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

Another term for this is *net worth*: the difference between what a firm owns (assets) minus what it owes (liabilities) is its net worth, or owners' equity. If a company's assets exceed its liabilities, owners' equity is *positive*. At Google, owners' equity is $46.241 billion (= $57.851 – $11.610). If the company goes out of business, the owners will receive some cash (a gain) after selling assets and paying off liabilities. If liabilities outweigh assets, owners' equity is *negative*; assets are insufficient to pay off all debts, and the firm is bankrupt. If the company goes out of business, the owners will get no cash, and some creditors won't be paid.

Owners' equity is meaningful for both investors and lenders. Before lending money to owners, for example, lenders want to know the amount of owners' equity in a business. A larger owners' equity indicates greater security for lenders. Owners' equity consists of two sources of capital:

1 The amount that the owners originally invested

2 Profits (also owned by the owners) earned by and reinvested in the company

When a company operates profitably, its assets increase faster than its liabilities. Owners' equity, therefore, will increase if profits are retained in the business instead of paid out as dividends to stockholders. Owners' equity also increases if owners invest more of their own money to increase assets. However, owners' equity can shrink if the company operates at a loss or if owners withdraw assets.

3 Describe the three basic financial statements and show how they reflect the activity and financial condition of a business.

Financial Statements

As noted previously, accountants summarize the results of a firm's transactions and issue reports to help managers make informed decisions. Among the most important reports are **financial statements,** which fall into three broad categories: *balance sheets*, *income statements*, and *statements of cash flows*. Together, these reports indicate the firm's financial health and what affected it. In this section, we discuss these three financial statements as well as the function of the budget as an internal financial statement.

Balance Sheets

Balance sheets supply detailed information about the accounting equation items: *assets*, *liabilities*, and *owners' equity*. Because they also show a firm's financial condition at one point in time, they are sometimes called *statements of financial position*. Figure 14.1 is a simplified presentation of the balance sheet for Google, Inc.

Assets From an accounting standpoint, most companies have three types of assets: *current*, *fixed*, and *intangible*.

Google, Inc.
Summary of Balance Sheet (condensed)
as of December 31, 2010
(in millions)

Assets	
Current assets:	
Cash	$13,630
Marketable securities	21,345
Other	6,587
Total current assets	**$41,562**
Fixed assets:	
Property and equipment, net	$7,759
Other	1,230
Total fixed assets	**$8,989**
Intangible assets:	
Intangible assets	$1,044
Goodwill	6,256
Total intangible assets	**$7,300**
Total assets	**$57,851**

Liabilities and Shareholders' Equity	
Current liabilities:	
Accounts payable	$6,137
Other	3,859
Total current liabilities	**$9,996**
Long-term liabilities:	
All long-term debts	$0
Other	1,614
Total long-term liabilities	**$1,614**
Total liabilities	**$11,610**
Shareholders' equity:	
Paid-in capital	$18,373
Retained earnings	27,868
Total shareholders' equity	**$46,241**
Total liabilities and shareholders' equity	**$57,851**

Google's balance sheet for year ended December 31, 2010. The balance sheet shows clearly that the firm's total assets are equal to its total liabilities and owners' equity.

Figure 14.1 Google's Balance Sheet
Source: Modified from "Google Inc. (GOOG)," *Yahoo! Finance*, accessed March 3, 2011 at http://finance.yahoo.com/q/bs?s=GOOG+Balance+Sheet&annual

Current Assets **Current assets** include cash and assets that can be converted into cash within a year. The act of converting something into cash is called *liquidating*. Assets are normally listed in order of **liquidity**—the ease of converting them into cash. Debts, for example, are usually paid in cash. A company that needs but cannot generate cash—a company that's not "liquid"—may be forced to sell assets at reduced prices or even to go out of business.

By definition, cash is completely liquid. *Marketable securities* purchased as short-term investments are slightly less liquid but can be sold quickly. These include stocks or bonds of other companies, government securities, and money market certificates. Many companies hold other nonliquid assets such as *merchandise inventory*—the cost of merchandise that's been acquired for sale to customers and is still on hand. Google has no merchandise inventory because it sells services rather than physical goods.

Fixed Assets **Fixed assets** (such as land, buildings, and equipment) have long-term use or value, but as buildings and equipment wear out or become obsolete, their value decreases. Accountants use **depreciation** to spread the cost of an asset over the years of its useful life. To reflect decreasing value, accountants calculate an asset's useful life in years, divide its worth by that many years, and subtract the resulting amount each year. Every year, therefore, the remaining value (or net value) decreases on the books. In Figure 14.1, Google shows fixed assets of $8.99 (rounded) billion after depreciation.

Intangible Assets Although their worth is hard to set, **intangible assets** have monetary value in the form of expected benefits, which may include fees paid by others

Owners' Equity amount of money that owners would receive if they sold all of a firm's assets and paid all of its liabilities

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

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

Intangible Asset nonphysical asset, such as a patent or trademark, that has economic value in the form of expected benefit for obtaining rights or privileges—including patents, trademarks, copyrights, and franchises—to your products. **Goodwill** is the amount paid for an existing business beyond the value of its other assets. A purchased firm, for example, may have a particularly good reputation or location. Google declares both intangible assets and goodwill in its balance sheet.

Liabilities Like assets, liabilities are often separated into different categories. **Current liabilities** are debts that must be paid within one year. These include **accounts payable (payables)**—unpaid bills to suppliers for materials as well as wages and taxes that must be paid in the coming year. Google has current liabilities of $10.00 (rounded) billion. **Long-term liabilities** are debts that are not due for at least a year. These normally represent borrowed funds on which the company must pay interest. The long-term liabilities of Google are $1.61 (rounded) billion.

Owners' Equity The final section of the balance sheet in Figure 14.1 shows owners' equity (shareholders' equity) broken down into *paid-in capital* and *retained earnings*. When Google was first formed, it sold a small amount of common stock that provided its first paid-in capital. **Paid-in capital** is money invested by owners. Google's paid-in capital had grown to $18.37 billion by year-end 2010, and includes proceeds from Google's initial public offering of stock in 2004 that created additional funds that were needed for expansion.

Retained earnings are net profits kept by a firm rather than paid out as dividend payments to stockholders. They accumulate when profits, which can be distributed to shareholders, are kept instead for the company's use. At the close of 2010, Google had retained earnings of $27.87 billion. The total of stockholders' equity—paid-in capital plus retained earnings—had grown to $46.24 billion.

The balance sheet for any company, then, is a barometer for its financial condition at one point in time. By comparing the current balance sheet with those of previous years, creditors and owners can better interpret the firm's financial progress and future prospects in terms of changes in its assets, liabilities, and owners' equity.

Income Statements

The **income statement** is sometimes called a **profit-and-loss statement** because its description of revenues and expenses results in a figure showing the firm's annual profit or loss. In other words,

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

Popularly known as the *bottom line*, profit or loss is probably the most important figure in any business enterprise. Figure 14.2 shows the 2010 income statement for Google, whose bottom line was $8.50 (rounded) billion. The income statement is divided into four major categories: *revenues*, *cost of revenues*, *operating expenses*, and *net income*. Unlike a balance sheet, which shows the financial condition at a specific *point in time*, an income statement shows the financial results that occurred during a *period of time*, such as a month, quarter, or year.

Revenues When a law firm receives $250 for preparing a will or a supermarket collects $65 from a grocery shopper, both are receiving **revenues**—the funds that flow into a business from the sale of goods or services. In 2010, Google reported revenues of $29.32 (rounded) billion from the sale of advertising and web-search services to Google Network members, such as AOL.

Cost of Revenues (Cost of Goods Sold) In the Google income statement, the **cost of revenues** section shows the costs of obtaining the revenues from other companies during the year. These are fees Google must pay its network members—revenue sharing from advertising income—and also include expenses arising from the operation of Google's data centers, including labor, energy, and costs of processing customer transactions. The cost of revenues for Google in 2010 was $10.42 (rounded) billion.

Figure 14.2 **Google's Income Statement**

Source: Modified from "Google Inc. (GOOG)," *Yahoo! Finance*, accessed March 3, 2011 at http://finance.yahoo.com/q/is?s=GOOG+Income+Statement&annual

Google, Inc.
Summary of Income Statement (condensed)
as of December 31, 2010
(in millions)

Revenues (gross sales)		**$29,321**
Cost of revenues	**10,417**	
Gross profit		**$18,904**
Operating expenses:		
Research Development	3,762	
Selling, Administrative and General	4,761	
Total operating expenses		**$8,523**
Operating income (before taxes)		10,381
Income taxes*		1,876
Net income		**$8,505**

*approximated

Google's income statement for year ended December 31, 2010. The final entry on the income statement, the bottom line, reports the firm's profit or loss.

While cost of revenues is a relevant income statement category for service providers like Google, goods producers do not use it. Instead, income statements for manufacturing firms such as Procter & Gamble use the corresponding category, **cost of goods sold:** costs of obtaining materials to make products sold during the year.

Gross Profit Managers are often interested in **gross profit,** a preliminary, quick-to-calculate profit figure that considers just two pieces of data—revenues and cost of revenues (the direct costs of getting those revenues)—from the income statement. To calculate gross profit, subtract cost of revenues from revenues obtained by selling the firm's products.

Operating Expenses In addition to costs directly related to generating revenues, every company has general expenses ranging from erasers to the CEO's salary. Like cost of revenues and cost of goods sold, **operating expenses** are resources that must flow out of a company if it is to earn revenues. As shown in Figure 14.2, Google had operating expenses of $8.53 billion (rounded).

Research development expenses result from exploring new services and technologies for providing them to customers. *Selling expenses* result from activities related to selling goods or services, such as sales-force salaries and advertising expenses. *Administrative and general expenses*, such as management salaries and maintenance costs, are related to the general management of the company.

Goodwill amount paid for an existing business above the value of its other assets

Current Liability debt that must be paid within one year

Accounts Payable (Payables) current liability consisting of bills owed to suppliers, plus wages and taxes due within the coming year

Long-Term Liability debt that is not due for at least one year

Paid-In Capital money that is invested in a company by its owners

Retained Earnings earnings retained by a firm for its use rather than paid out as dividends

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 funds that flow into a business from the sale of goods or services

Cost of Revenues costs that a company incurs to obtain revenues from other companies

Cost of Goods Sold costs of obtaining materials for making the products sold by a firm during the year

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 Expenses costs, other than the cost of revenues, incurred in producing a good or service

Operating and Net Income **Operating income** compares the gross profit from operations against operating expenses. This calculation for Google ($18.90 billion – $8.52 billion) reveals an operating income, or income before taxes, of $10.38 billion. Subtracting income taxes from operating income ($10.38 billion – $1.88 billion) reveals **net income (net profit or net earnings).** Google's net income for the year was $8.50 billion (rounded).

The step-by-step information in an income statement shows how a company obtained its net income for the period, making it easier for shareholders and other stakeholders to evaluate the firm's financial health.

Statements of Cash Flows

Some companies prepare only balance sheets and income statements. However, the SEC requires all firms whose stock is publicly traded to issue a third report, the **statement of cash flows,** which describes yearly cash receipts and cash payments. Since it provides the most detail about how the company generates and uses cash, some investors and creditors consider it one of the most important statements of all. It shows the effects on cash of three aspects of a business: *operating activities*, *investing activities*, and *financing activities*. Google's 2010 statement (simplified) of cash flows is reproduced in Figure 14.3.

- Cash Flows from Operations. This first section of the statement concerns main operating activities: cash transactions involved in buying and selling goods and services. For the Google example, it reveals how much of the year's cash balance results from the firm's main line of business—sales of advertising and web-search services. Operating activities at Google contributed net cash inflows amounting to $11.08 (rounded) billion in 2010.
- Cash Flows from Investing. The second section reports net cash used in or provided by investing. It includes cash receipts and payments from buying and selling stocks, bonds, property, equipment, and other productive assets. These sources of cash are not the company's main line of business. Purchases of property, equipment, and investments made by Google consumed $10.68 billion of net cash. A cash outflow is shown in parentheses.
- Cash Flows from Financing. The third section reports net cash from all financing activities. It includes cash inflows from borrowing or issuing stock, as well as outflows for payment of dividends and repayment of borrowed money. Google's financing activities provided a net cash inflow of $3.05 billion.

Figure 14.3 **Google's Statement of Cash Flows**
Source: Modified from "Google Inc. (GOOG)," *Yahoo! Finance*, accessed March 3, 2011 at http://finance.yahoo.com/q/cf?s=GOOG+Cash+Flow&annual

Google, Inc.
Summary of Statement of Cash Flows (condensed)
as of December 31, 2010
Increase (Decrease) in Cash
(in millions)

Net cash provided by operating activities		**$11,081.**
Cash from investments:		
Purchases of property, equipment, and investments	(11,974.)	
Cash inflows from investment activities	1,294.	
Net cash used in investing activities		**(10,680.)**
Cash flows from financing activities:		
Purchase of stock	(801.)	
Borrowings	3,463.	
Other	388.	
Net cash provided by financing activities		**3,050.**
Net increase in cash		3,451.
Cash at beginning of year		10,179.
Cash at end of year		**$13,630.**

Google's statement of cash flows for year ended December 31, 2010. The final entry shows year-end cash position resulting from operating activities, investing activities, and financing activities.

The overall change in cash from these three sources is $3.45 (rounded) billion for the year. The amount is added to the beginning cash (year-end cash from the 2009 balance sheet) to arrive at 2010's ending cash position of $13.63 billion. When creditors and stockholders know how a firm obtained and used funds during the course of a year, it's easier for them to interpret year-to-year changes in the balance sheet and income statement.

The Budget: An Internal Financial Statement

For planning, controlling, and decision making, the most important internal financial statement is the **budget**—a detailed report on estimated receipts and expenditures for a future period of time. Although that period is usually one year, some companies also prepare three- or five-year budgets, especially when considering major capital expenditures. The budget differs from the other statements we have discussed in that budgets are not shared outside the company; hence the "internal financial statement" title.

Although the accounting staff coordinates the budget process, it needs input from many areas regarding proposed activities and required resources. Figure 14.4 is a sales budget for a hypothetical wholesaler, Perfect Posters. In preparing the budget, accounting must obtain from the sales group projections for units to be sold and expected expenses for the coming year. Then, accounting draws up the final budget and, throughout the year, compares the budget to actual expenditures and revenues. Discrepancies signal potential problems and spur action to improve financial performance.

Reporting Standards and Practices

4 Explain the key standards and principles for reporting financial statements.

Accountants follow standard reporting practices and principles when they prepare external reports. The common language dictated by standard practices and spelled out in GAAP is designed to give external users confidence in the accuracy

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

Perfect Posters, Inc.
Sales Budget
First Quarter, 2012

	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 14.4 **Perfect Posters' Sales Budget**

Operating Income gross profit minus operating expenses

Net Income (Net Profit, Net Earnings) gross profit minus operating expenses and income taxes

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

Budget detailed statement of estimated receipts and expenditures for a future period of time and meaning of financial information. The GAAP principles cover a range of issues, such as when to recognize revenues from operations and how to make full public disclosure of financial information. Without such standards, users of financial statements wouldn't be able to compare information from different companies, and would misunderstand—or be led to misconstrue—a company's true financial status. Forensic accountants such as PricewaterhouseCoopers's Al Vondra watch for deviations from GAAP as indicators of possible fraudulent practices.

Revenue Recognition and Activity Timing The reporting of revenue inflows, and the timing of other transactions, must abide by accounting principles that govern financial statements. **Revenue recognition,** for example, is the formal recording and reporting of revenues at the appropriate time. Although a firm earns revenues continuously as it makes sales, earnings are not reported until the *earnings cycle* is completed. This cycle is complete under two conditions:

1 The sale is complete and the product delivered.

2 The sale price has been collected or is collectible (accounts receivable).

The end of the earnings cycle determines the timing for revenue recognition in a firm's financial statements. Suppose a toy company in January signs a sales contract to supply $1,000 of toys to a retail store, with delivery scheduled in February. Although the sale is completed in January, the $1,000 revenue should not then be recognized because the toys have not been delivered and the sale price is not yet collectible, so the earnings cycle is incomplete. Revenues are recorded in the accounting period—February—in which the product is delivered and collectible (or collected). This practice ensures that the statement gives a fair comparison of what was gained (revenues) in return for the resources that were given up (cost of materials, labor, and other production and delivery expenses) for the transaction.

Full Disclosure To help users better understand the numbers in a firm's financial statements, GAAP requires that financial statements also include management's interpretations and explanations of those numbers. This is known as the **full disclosure** principle. Because they know about events inside the company, managers prepare additional information to explain certain events or transactions or to disclose the circumstances behind certain results. For example, earlier annual reports and financial statements filed by Borders, the well-known bookseller, had discussed the competitive and economic risks facing the company before it eventually filed for bankruptcy in 2011. The disclosures noted that consumer spending trends were shifting to Internet retailers and eBooks, and away from in-store purchasing, thus posing risks for Borders' cash flows and overall financial condition. Management's discussion noted there could be no assurance that Borders would muster adequate financial resources to remain competitive and, indeed, it soon happened. Upon filing for bankruptcy, Borders' liabilities of $1.29 billion had surpassed its assets of $1.28 billion.[13]

5 Describe how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business.

Analyzing Financial Statements

Financial statements present a lot of information, but how can it be used? How, for example, can statements help investors decide what stock to buy or help lenders decide whether to extend credit? Answers to such questions for various stakeholders—employees, managers, unions, suppliers, the government, customers—can be answered as follows: Statements provide data, which can, in turn, reveal trends and be applied to create various *ratios* (comparative numbers). We can then use these trends and ratios to evaluate a firm's financial health, its progress, and its prospects for the future.

MANAGING IN TURBULENT TIMES

The "Fairness" Dilemma: What's an Asset's Real Value?

Think of a personal possession, such as a car. What is its monetary worth, or value? Is it the amount you paid, or what you could get by selling it today, or what you would expect if you sell two years from now? Businesses face similar questions when valuing assets on the balance sheet. Consider the Boston home buyer who paid $475,000 in 2006 when a bank generously valued the property at more than $525,000, allowing the new homeowner to borrow the full amount of the purchase price. The bank's asset (the mortgage loan) was valued at $475,000 and the borrower's property was valued at $525,000. Today, the borrower has vacated the house, unable to make payments. The bank holds the repossessed the property; it is unsellable at a $360,000 asking price. In the event of future economic recovery, the bank expects that the property will be worth at least $500,000. So, what should be the asset value on the balance sheet—$475,000 or $360,000 or $500,000? Many other firms in addition to banks are grappling with such questions in the plunging real estate market.[14]

The core problem is market shutdown: In a recession, there is no functioning market that sets a "fair market price" for many assets. With no buyers, once-valuable properties and financial investments have become "toxic assets": They are unsellable, often having no current market value. Difficulty worsens when market shutdown runs headlong into an accounting rule known as "mark-to-market," resulting in potential business closures.[15]

Mark-to-market—or "fair value accounting"—requires that assets be priced on balance sheets at current market value. That forces a major write-down for toxic assets at companies facing inactive markets for housing, cars, and financial securities, and it forces accounting losses that may cause "bleeding" companies to fold. Advocates for relaxing mark-to-market argue that presently distressed assets will become more valuable later, as the economy recovers, so currently depressed values are not at all "fair" indicators of their worth. Instead, they say, mark-to-market exaggerates the scale of their losses in an economic downturn.[16]

ericsphotography/iStockphoto

Relief for some troubled firms came in early 2009, with unusual action by the U.S. Financial Accounting Standards Board (FASB), an independent organization that sets accounting guidelines. FASB relaxed mark-to-market accounting for financial institutions. Banks now have more flexibility for valuing toxic assets, using estimates from their internal computer models instead of reporting assets at currently distressed market prices. Opponents to the change, however, warn that relaxed rules could let banks hide the true, low value of assets and deceive investors at a time when trust in financial reporting is most needed.[17]

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Ratios are normally grouped into three major classifications:

1 **Solvency ratios** for estimating short-term and long-term risk

2 **Profitability ratios** for measuring potential earnings

3 **Activity ratios** for evaluating management's use of assets

Depending on the decisions to be made, a user may apply none, some, or all of these ratios.

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

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

Solvency Ratios: Borrower's Ability to Repay Debt

What are the chances that a borrower will be able to repay a loan and the interest due? This question is first and foremost in the minds of bank lending officers, managers of pension funds and other investors, suppliers, and the borrowing company's own financial managers. Solvency ratios provide measures of a firm's ability to meet its debt obligations.

The Current Ratio and Short-Term Solvency

Short-term solvency ratios measure a company's liquidity and its ability to pay immediate debts. The most commonly used of these is the **current ratio,** or "banker's ratio." This measures a firm's ability to generate cash to meet current obligations through the normal, orderly process of selling inventories and collecting revenues from customers. It is calculated by dividing current assets by current liabilities. The higher a firm's current ratio, the lower the risk to investors.

As a rule, a current ratio is satisfactory at 2:1 or higher—that is, if current assets more than double current liabilities. A smaller ratio may indicate that a firm will have trouble paying its bills.

How does Google measure up? Look again at the balance sheet in Figure 14.1. Judging from current assets and current liabilities at the end of 2010, we see that

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$41.56 \text{ billion}}{\$10.00 \text{ billion}} = 4.2$$

The industry average for companies that provide business services is 1.4. Google's current ratio of 4.2 indicates the firm is a good short-run credit risk.

Long-Term Solvency

Stakeholders are also concerned about long-term solvency. Has the company been overextended by borrowing so much that it will be unable to repay debts in future years? A firm that can't meet its long-term debt obligations is in danger of collapse or takeover—a risk that makes creditors and investors quite cautious. To evaluate a company's risk of running into this problem, creditors turn to the balance sheet to see the extent to which a firm is financed through borrowed money. Long-term solvency is calculated by dividing **debt**—total liabilities—by owners' equity. The lower a firm's debt, the lower the risk to investors and creditors. Companies with more debt may find themselves owing so much that they lack the income needed to meet interest payments or to repay borrowed money.

Leverage Sometimes, high debt can be not only acceptable, but also desirable. Borrowing funds gives a firm **leverage**—the ability to make otherwise unaffordable investments. In *leveraged buyouts*, firms have willingly taken on sometimes huge debts to buy out other companies. If owning the purchased company generates profits above the cost of borrowing the purchase price, leveraging often makes sense. Unfortunately, many buyouts have caused problems because profits fell short of expected levels or because rising interest rates increased payments on the buyer's debt.

Profitability Ratios: Earnings Power for Owners

It's important to know whether a company is solvent in both the long and the short term, but risk alone is not an adequate basis for investment decisions. Investors also want some indication of the returns they can expect. Evidence of earnings power is available from profitability ratios, such as *earnings per share*.

Earnings per Share

Defined as net income divided by the number of shares of common stock outstanding, **earnings per share** determines the size of the dividend that a firm can pay shareholders. As an indicator of a company's wealth potential, investors use this ratio to decide whether to buy or sell the firm's stock. As the ratio goes up, stock value increases because investors know that the firm can better afford to pay dividends. Naturally, stock loses market value if financial statements report a decline in earnings per share. For Google, we can use the net income total from the

ENTREPRENEURSHIP AND NEW VENTURES

How Will Twitter Turn Tweets into Treasure?

Widely accepted accounting measurements provide useful information about established firms but are a bit foggier with start-ups. Consider the continuing questions from the investment community about Twitter's ambiguous financial status. With several firms interested in buying Twitter, how can they know its market value, variously estimated to have risen from an early $300 million up to $4.5 billion in 2011, without solid financial data? The real numbers are confidential in closely held Twitter. As to its profitability, Twitter reports, "we spend more money than we make." Since Twitter was launched in 2006, its total losses have not been reported publicly. When (and how) will losses blossom into profitability? As stated by cofounder and former CEO Evan Williams, "We will make money, and I can't say exactly how because . . . we can't predict how the businesses we're in will work." And until they know *how*, they don't know *when* profits will occur.[18]

Twitter's balance sheet is another source of ambiguity. The accounting equation requires a fixed relationship among three items: Assets = Liabilities + Owners' Equity. Twitter insiders have a clear accounting of its outstanding liabilities. Paid-in capital (a part of shareholders' equity) is known, too: It includes the cofounders' personal investments plus a series of venture capital infusions, bringing the suspected total to over $800 million.

Questions also arise for valuing assets. For example, Twitter acquired the assets of *Values of n* to get needed technology and intellectual property into its operations. Exactly how Twitter will use them is unknown, so how should they be valued? Twitter's greatest asset is a massive loyal customer base with a phenomenal growth rate—190 million visitors per month and 65 million Tweets daily—and its enormous advertising potential. Celebrities, media, politicians, and organizations such as Papa Johns, American Red Cross, Warner Bros Pictures, and Toyota USA are using Twitter for sales and marketing promotions. Should this untapped advertising potential be recognized as an intangible asset? At what value? While the company's market, customer base, and products are rapidly emerging, how should its many assets—tangible and intangible—be valued? On what basis can those valuations be justified? Clearly, these issues at Twitter are less well settled than at well-established firms.[19]

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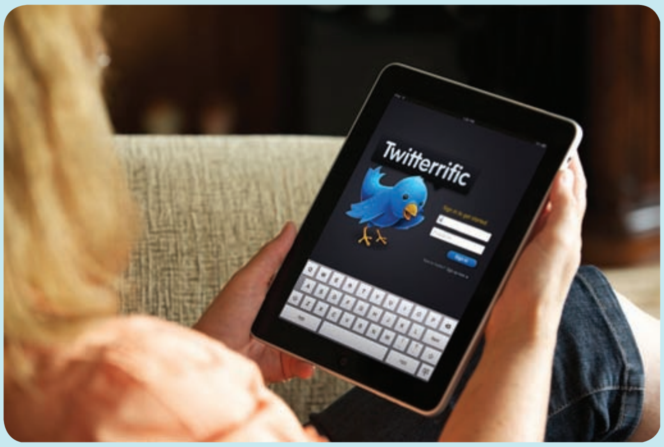

Pixellover RM 1/Alamy

income statement in Figure 14.2, together with the number of outstanding shares of stock, to calculate earnings per share as follows:

$$\frac{\text{Net income}}{\text{Number of common shares outstanding}} = \frac{\$8{,}505.0 \text{ million}}{321.5 \text{ million shares of stock}} = \$26.45 \text{ per share}$$

This means that Google had net earnings of $26.45 (rounded) for each share of stock during 2010. In contrast, Time Warner's recent earnings were $2.25 per share, while Microsoft earned $2.34.

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

Debt company's total liabilities

Leverage ability to finance an investment through borrowed funds

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

Activity Ratios: How Efficiently Is the Firm Using Its Resources?

The efficiency with which a firm uses resources is linked to profitability. As a potential investor, you want to know which company gets more mileage from its resources. Information obtained from financial statements can be used for *activity ratios* to measure this efficiency. For example, two firms use the same amount of resources or assets to perform a particular activity. If Firm A generates greater profits or sales, it has used its resources more efficiently and so enjoys a better activity ratio. It may apply to any important activity, such as advertising, sales, or inventory management. Consider the activity of using the firm's resources to increase sales. As an example, suppose from its income statements we find that Google increases its annual sales revenues and does it without increasing it operating costs. Its sales activity has become more efficient. Investors like to see these year-to-year increases in efficiencies because it means the company is getting "more bang for the buck"—revenues are increasing faster than costs.

6 Discuss the role of ethics in accounting.

Bringing Ethics into the Accounting Equation

The purpose of ethics in accounting is to maintain public confidence in business institutions, financial markets, and the products and services of the accounting profession. Without ethics, all of accounting's tools and methods would be meaningless because their usefulness depends, ultimately, on veracity in their application.

Why Accounting Ethics?

Amidst a flurry of unscrupulous activity, ethics remains an area where one person who is willing to "do the right thing" can make a difference—and people do, every day. The role of ethics in the ground-breaking scandal from a decade ago remains a classic example: Refusing to turn a blind eye to unethical accounting around her at Enron, Lynn Brewer tried to alert people inside about misstatements of the company's assets. When that failed, she, along with colleagues Sherron Watkins and Margaret Ceconi, talked with the U.S. Committee on Energy and Commerce to voice concerns about Enron's condition. To Brewer, maintaining personal and professional integrity was an overriding concern, and she acted accordingly.

AICPA's Code of Professional Conduct The **code of professional conduct** for public accountants in the United States is maintained and enforced by the AICPA. The institute identifies six ethics-related areas—listed in Table 14.3—with which accountants must comply to maintain certification. Comprehensive details for compliance in each area are spelled out in the AICPA Code of Professional Conduct. The IMA maintains a similar code to provide ethical guidelines for the management accounting profession.

In reading the AICPA's Code, you can see that it forbids misrepresentation and fraud in financial statements. Deception certainly violates the call for exercising moral judgments (in "Responsibilities"), is contrary to the public interest (by deceiving investors) and does not honor the public trust (in "The Public Interest"). Misleading statements destroy the public's confidence in the accounting profession and in business in general. While the Code prohibits such abuses, its success depends, ultimately, on its acceptance and use by the professionals it governs.

Violations of Accounting Ethics and GAAP Unethical and illegal accounting violations have dominated the popular press in recent years. Some of the more

TABLE 14.3 Highlights from the Code of Ethics for CPAs

By voluntarily accepting Certified Public Accountant membership, the accountant also accepts self-enforced obligations, listed below, 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	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 for clients.

Source: Based on "Code of Professional Conduct," *AICPA*, at http://infotech.aicpa.org/Resources/Privacy/Federal+State+and+Other+Professional+Regulations/AICPA+Code+of+Professional+Conduct/.

notorious cases, listed in Table 14.4, violated the public's trust, ruined retirement plans for thousands of employees, and caused shutdowns and lost jobs. As you read each case, you should be able to see how its violation relates to the presentation of balance sheets and income statements in this chapter. In each case, adversity would have been prevented if employees had followed the code of professional conduct. In each case, nearly all of the code's six ethics-related areas were violated. And in every case, "professionals" willingly participated in unethical behavior. Such was the impetus for Sarbox.

TABLE 14.4 Examples of Unethical and Illegal Accounting Actions[20]

Corporation	Accounting Violation
AOL Time Warner	America Online (AOL) inflated ad revenues to keep stock prices high before and after merging with Time Warner.
Cendant	Inflated income in financial statements by $500 million through fraud and errors.
HCA, Columbia/HCA	Defrauded Medicare, Medicaid, and TRICARE through false cost claims and unlawful billings (must pay $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.

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

7 Describe the purpose of the International Accounting Standards Board and explain why it exists.

Internationalizing Accounting

Accounting in its earliest forms is known to have existed more than 7,000 years ago in Mesopotamia and Egypt for recording trade transactions and keeping track of resources. With the passage of time each country or region's accounting practices were refined to meet its needs in commerce while also accommodating local cultural traditions and developments in its laws. While unique practices served each region well, they later posed problems as international business became prominent. By the late 20th century it was apparent that the upsurge in multinational organizations and the global economy demanded more uniformity among accounting practices. The development of "universal" procedures would allow governments and investors in, say, China, Brazil, and Italy to read, interpret, and compare financial statements from all those countries, whereas such comparisons even today are difficult if not sometimes impossible.

International Accounting Standards Board

Established in 2001 and housed at London, England, the **International Accounting Standards Board (IASB)** is an independent, nonprofit organization responsible for developing a set of global accounting standards, and for gaining the support and cooperation of the world's various accounting organizations to implement those standards.

IASB's 15 board members from various countries are full-time accounting experts with technical and international business experience.[21] Because the Board cannot command sovereign nations to accept its recommended standards, its commitment to gaining cooperation around the world is a continuing task. Yet, international acceptance is essential for success. Accordingly, the Board's task is a long-term process that requires working with various countries to design proposed standards. As an example, for any IASB proposal to be accepted in the U.S., it must first be approved by the U.S.-based Financial Accounting Standards Board (FASB) and by the U.S. Securities and Exchange Commission. However, IASB's efforts extend beyond the U.S., to all nations. The expected timeline reaches beyond 2015 for convergence of the many local GAAP's into one global set of practices.

Why One Set of Global Practices?

Although more than 100 countries have adopted IASB's accounting practices, nearly 40 others, including China, Canada, and the U.S., continue to use their national GAAPs.[22] U.S.-based global companies such as Google, Caterpillar, and Microsoft may prepare different financial reports using local accounting practices for each country in which they conduct business. They also report the company's overall performance in a set of consolidated statements that combines the financial results of all its global affiliates, using U.S.-GAAP. Using different accounting standards, however, can result in vastly different pictures of a firm's financial health. Income statements, balance sheets, and statements of cash flows using local GAAPs versus IASB practices, for example, may contain conflicting information with inconsistencies leading to confusion and misunderstandings among investors and other constituents. To emphasize this point, Sir David Tweedie, Chairman of the IASB notes that a company using IASB standards can report balance sheet figures that are twice the size of those using U.S. GAAP accounting standards.[23] Which of the reports tells how well the company is doing? Such inconsistencies in reporting are unacceptable in a global economy and, accordingly, protection against them is a goal of IASB.

Example Areas Targeted for Aligning U.S. GAAP and IASB Among the many differences between the practices of U.S. GAAP and IASB—some reports identify more than 400 such discrepancies—the following examples illustrate some discrepancies and proposals for convergence toward universal standards in financial reporting.

**In valuing assets* (reported on the balance sheet), U.S. GAAP allows an asset to be written down if for some reason its value decreases. However, the value cannot later be rewritten up, even if it its actual value has increased. IASB standards, in contrast, do allow such write-ups reflecting increased market value, so the reported value of a company's assets can be quite different, depending upon the chosen accounting system.[24]

**In revenue recognition*—when revenues from customers should be recognized (reported), and in what amounts—on the income statement, the U.S. GAAP and IASB procedures differ. A current joint proposal, if approved, would remove existing inconsistencies and provide a single standard that recognizes revenue at the time the goods and services are transferred to the customer, and in the amounts that are expected to be received (or are received) from the customer.[25]

**In de-valuing of financial assets*—such as writing down bad loans in the financial crisis—both U.S. GAAP and IASB currently use the same procedure: After a loss occurs (but not until after the fact) the loan's value can be written down in the firm's financial statements, reflecting its lower value. Both groups, however, believe an "expected loss model" that recognizes (and reports) likely loan losses *ahead of time* will provide more timely information for investors and financial planners. A joint proposal for such a procedure has been presented.[26]

**In fair value disclosure* the FASB and IASB jointly propose new standards for improving the comparability of fair value disclosures in financial statements. Unlike dissimilar disclosure practices among many local GAAPs, both groups want the reported "fair value" for an asset, a liability, and an item in shareholders' equity to have the same meaning under both FASB and IASB procedures. The disclosure should identify the techniques and inputs used to measure fair value so that users can more clearly assess and compare financial statements.[27]

Timetable for Implementation The U.S. Securities and Exchange Commission has targeted 2015 as the earliest date that U.S. companies will be required to use IASB procedures for financial reporting. First, however, IASB must demonstrate that its standards are developed adequately for use in the U.S. financial reporting system. This would include assuring that investors have developed an understanding of and education in using IASB standards. Accounting education, too, must be updated to prepare U.S. accounting students for IASB, as well as updating practitioners in CPA firms. AICPA has announced plans to test for knowledge of international standards in CPA examinations by 2012. Finally, the SEC must make a decision to phase in IASB all at once or, instead, to sequence its adoption beginning with a limited number of companies before final phase-in.[28]

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

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Fraud-Finding and Fraud-Prevention: The Stakes Are Getting Higher

Fraudulent insurance claims are on the upswing: A private investigator films an injury victim throwing the neck brace into the back seat of his car after leaving the doctor's office, a homeowner inflates the cost of articles stolen in an alleged burglary, and victims of car wrecks from years past suddenly submit injury claims. Employees, too, are a source of fraud: The U.S. Commerce Department estimates that one-third of business shutdowns are due to employee theft. Inventory stolen from the firm's warehouse is resold; the company's strategic inside information is stolen and sold to a competitor; and employees receive reimbursement for falsely inflated business expenses. [29]

The broad scope of fraud—its costs, who commits it and how, and how it is detected—is revealed in *Global Fraud Studies* conducted by the Association of Certified Fraud Examiners (ACFE).[30] Fraud typically costs organizations five percent of their annual revenues, but small businesses are especially vulnerable because they usually have fewer internal controls for protecting their resources. Employees in the United States commit more cases of fraud than do managers, while top-level executives and owners are least involved. However, it comes as no surprise that financial losses by higher-level perpetrators is typically ten times that of other employees. The most common kind of fraud is asset theft—stealing cash, falsifying business expenses, forging checks, and stealing noncash assets. The Chief Financial Officer of a Florida tree farm, for example, falsified checks and misused company credit cards to embezzle $10 million, earning a 96-month prison sentence and a $14 million fine.[31] The least-common organizational fraud and the costliest by far, is financial statement manipulation. In 2011, for example, the officer of an investment company was convicted of lying to investors using quarterly statements reporting inflated earned interest on bank accounts. The result was a 36-month prison sentence and an order to pay bilked investors some $183 million in restitution.

How do they get caught? Most commonly, detection starts from tips by employees. While internal audits are somewhat effective, external audits are less effective than commonly believed, and less than detection by accident! The CFE study concludes any organization's number-one safeguard is employee education in recognizing, reporting, and preventing fraud.

QUESTIONS FOR DISCUSSION

1. What factors do you think are most important in choosing among various methods to protect against fraud in your firm?
2. Suppose you are hoping for a career as a certified fraud examiner. How do recent trends in fraud provide new opportunities for such a career?
3. An external auditor, such as a CPA firm's accountant, may suspect some irregularities in a client firm's accounting practices. In what ways might a certified fraud examiner be of assistance?
4. Consider the anti-fraud training for a company's employees. Which four (or more) topics should be included in that training?
5. What ethical issues, if any, are involved in a decision to investigate a suspected case of fraud in a firm's accounting activities?

SUMMARY OF LEARNING OBJECTIVES

MyBizLab

1. **Explain the role of accountants and distinguish between the kinds of work done by public accountants, private accountants, management accountants, and forensic accountants. (p. 358–363)**
The role of accountants is to maintain a comprehensive system for collecting, analyzing, and communicating financial information for use by external constituents and within firms for planning, controlling, and decision making. It measures business performance and translates the results into information for management decisions. *Certified public accountants (CPAs)* are licensed professionals who provide auditing, tax, and management advisory services for other firms and individuals. Only CPAs can audit a firm's financial statements, and CPAs are always independent of the firms they audit. Many businesses hire their own salaried employees—*private accountants*—to perform internal accounting activities, such as internal auditing, taxation, cost analysis, and budgeting. Among private accountants, *certified management accountants* have passed the profession's experience and examination requirements for proficiency to provide internal accounting services that support managers in various activities (such as marketing, production, and engineering). *Forensic accountants* use accounting for legal purposes by providing investigative and litigation support in crimes against companies, crimes by companies, and civil cases.

2. **Explain how the accounting equation is used. (pp. 363–364)**
Accountants use the following equation to balance the data pertaining to financial transactions:

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$$

After each financial transaction (e.g., payments to suppliers, sales to customers, wages to employees), the accounting equation must be in balance. If it isn't, then an accounting error has occurred. The equation also provides an indication of the firm's financial health. If assets exceed liabilities, owners' equity is positive; if the firm goes out of business, owners will receive some cash (a gain) after selling assets and paying off liabilities. If liabilities outweigh assets, owners' equity is negative; assets aren't enough to pay off debts. If the company goes under, owners will get no cash and some creditors won't be paid, thus losing their remaining investments in the company.

3. **Describe the three basic financial statements and show how they reflect the activity and financial condition of a business. (pp. 364–369)**
Accounting summarizes the results of a firm's transactions and issues reports—including *financial statements*—to help managers and other stakeholders make informed decisions. (1) The *balance sheet* (sometimes called the *statement of financial position*) supplies detailed information about the accounting equation items—assets, liabilities, and owners' equity—that together are a barometer of the firm's financial condition at a point in time. By comparing the current balance sheet with those of previous years, creditors and owners can better interpret the firm's financial progress and future prospects. (2) The *income statement* (sometimes called a *profit-and-loss statement*) describes revenues and expenses to show a firm's annual profit or loss during a period of time, such as a year. (3) A publicly traded firm must issue a *statement of cash flows*, which describes its yearly cash receipts (inflows) and payments (outflows). It shows the effects on cash during the year from three kinds of business activities: (a) cash flows from operations, (b) cash flows from investing, and (c) cash flows from financing. The statement of cash flows then reports the overall change in the company's cash position at the end of the accounting period.

4. **Explain the key standards and principles for reporting financial statements. (pp. 369–370)**
Accountants follow standard reporting practices and principles when they prepare financial statements. Otherwise, users wouldn't be able to compare information from different companies, and they might misunderstand—or be led to misconstrue—a company's true financial status. The following are two of the most important standard reporting practices and principles: (1) *Revenue recognition* is the formal recording and reporting of revenues in financial statements. All firms earn revenues continuously as they make sales, but earnings are not reported until the earnings cycle is completed. This cycle is complete under two conditions: (a) The sale is complete and the product delivered; (b) the sale price has been collected or is collectible. This practice assures interested parties that the statement gives a fair comparison of what was gained for the resources that were given up. (2) *Full disclosure* recognizes that a firm's managers have inside knowledge—beyond just the numbers reported in its financial statements—that can explain certain events, transactions, or otherwise disclose the circumstances behind certain results. Full disclosure means that financial statements include management interpretations and explanations to help external users understand the financial information contained in statements.

5. **Describe how computing financial ratios can help users get more information from financial statements to determine the financial strengths of a business. (pp. 370–374)**
Financial statements contain data that can be used in *ratios* (comparative numbers) to analyze the financial health of a company in terms of solvency, profitability, and efficiency in performing activities. Ratios can help creditors, investors, and managers assess a firm's current status and check its progress by comparing current with past statements. *Solvency ratios* use balance sheet data to measure the firm's ability to meet (repay) its debts. The *current ratio* measures the ability to meet current (short-term) liabilities out of current assets. *Long-term solvency ratios* compare the firm's total liabilities (including long-term debt) against the owners' equity. High indebtedness (a high ratio) can be risky because it requires payment of interest and repayment of borrowed funds that may not be available. *Profitability ratios*, such as earnings per share, measure current and potential earnings. *Activity ratios* reflect management's use of assets by measuring the efficiency with which a firm uses its resources for a particular activity, such as sales, advertising, or inventory management. Sales efficiency, for

example, can be measured from income statement data for annual sales revenues as compared with sales expenses. Sales efficiency has increased if the year-to-year growth in sales revenues is larger than the growth in sales expenses.

6. Discuss the role of ethics in accounting. (pp. 374–375) The purpose of ethics in accounting is to maintain public confidence in business institutions, financial markets, and the products and services of the accounting profession. Without ethics, all of accounting's tools and methods would be meaningless because their usefulness depends, ultimately, on truthfulness in their application. Accordingly, professional accounting associations enforce codes of professional conduct that include ethics-related areas, such as the accountant's responsibilities, the public interest, integrity, and due care. The associations include ethics as an area of study to meet requirements for certification. The codes prohibit, among other areas, misrepresentation and fraud in financial statements. While the accounting profession relies generally on self-compliance to professional codes, accounting associations maintain ethical conduct committees to receive allegations, hold hearings, reach settlements, and impose penalties for misconduct. The flare-up of unethical and illegal corporate accounting violations was the impetus for the Sarbanes-Oxley Act of 2002, thus placing even greater emphasis and public awareness on the importance of ethics in accounting.

7. Describe the purpose of the International Accounting Standards Board and explain why it exists. (pp. 376–377) The International Accounting Standards Board (IASB) is an independent, nonprofit organization established for the purpose of developing a set of global accounting standards, and for gaining the support and cooperation of the world's various accounting organizations to implement those standards. It exists because the upsurge in multinational organizations and the global economy demands more uniformity among accounting practices, so that accounting reports become more understandable across nations and regions. Although more than 100 countries have adopted IASB's accounting practices, nearly 40 others continue to use their national accounting standards that are often not comparable and can result in vastly different pictures of a firm's financial health. The development of "universal" procedures would allow governments and investors everywhere to read, interpret, and compare financial statements from every country, whereas such comparisons even today are difficult if not sometimes impossible.

KEY TERMS MyBizLab

accounting (p. 358)
accounting equation (p. 363)
accounting information system (AIS) (p. 358)
accounts payable (payables) (p. 366)
activity ratio (p. 371)
asset (p. 363)
audit (p. 359)
balance sheet (p. 364)
bookkeeping (p. 358)
budget (p. 369)
Certified Fraud Examiner (CFE) (p. 362)
certified management accountant (CMA) (p. 361)
certified public accountant (CPA) (p. 359)
code of professional conduct (p. 374)
controller (p. 358)
core competencies for accounting (p. 360)
cost of goods sold (p. 367)
cost of revenues (p. 366)
current asset (p. 365)
current liability (p. 366)
current ratio (p. 372)
debt (p. 372)
depreciation (p. 365)
earnings per share (p. 372)
financial accounting (p. 358)
financial statement (p. 364)
fixed asset (p. 365)
forensic accounting (p. 361)
full disclosure (p. 370)
generally accepted accounting principles (GAAP) (p. 359)
goodwill (p. 366)
gross profit (p. 367)
income statement (profit-and-loss statement) (p. 366)
intangible asset (p. 365)
International Accounting Standards Board (IASB) (p. 376)
leverage (p. 372)
liability (p. 363)
liquidity (p. 365)
long-term liability (p. 366)
management accountant (p. 361)
management advisory services (p. 360)
managerial (management) accounting (p. 359)
net income (net profit, net earnings) (p. 368)
operating expenses (p. 367)
operating income (p. 368)
owners' equity (p. 364)
paid-in capital (p. 366)
private accountant (p. 361)
profitability ratio (p. 371)
retained earnings (p. 366)
revenue recognition (p. 370)
revenues (p. 366)
Sarbanes-Oxley Act of 2002 (SARBOX or SOX) (p. 362)
short-term solvency ratio (p. 372)
solvency ratio (p. 371)
statement of cash flows (p. 368)
tax services (p. 360)

QUESTIONS AND EXERCISES

QUESTIONS FOR REVIEW

1. Who are the users of accounting information, and for what purposes do they use it?
2. Identify the three types of services performed by CPAs.
3. Explain the ways in which financial accounting differs from managerial (management) accounting.
4. Discuss the activities and services performed by forensic accountants.
5. What are the three basic financial statements, and what major information does each contain?
6. Explain how financial ratios allow managers to gain additional information from financial statements.

QUESTIONS FOR ANALYSIS

7. If you were planning to invest in a company, which of the three types of financial statements would you most want to see? Why?
8. Suppose that you, as the manager of a company, are making changes to fully comply with provisions of the Sarbanes-Oxley Act. Your company traditionally has relied on CPA firms for auditing, tax services, and management services. What major changes will your company need to make?
9. Consider possible reasons why it is taking so long for IASB's international accounting standards to become fully adopted for use in the United States. Using the Internet as your source for information, identify five or more barriers that have deterred implementation of the standards, and explain how (or why) each has (or is) causing implementation delays.

APPLICATION EXERCISES

10. Interview an accountant at a local firm. How does the firm use budgets? How does budgeting help managers plan business activities? How does budgeting help them control activities? Give examples.
11. Interview the manager of a local retailer, wholesale business, or manufacturing firm about the role of ethics in that company's accounting practices. Is ethics in accounting an important issue to the manager? If the firm has its own private accountants, what measures are taken for ensuring ethical practices internally? What steps, if any, does the company take to maintain ethical relationships in its dealings with CPA firms?

BUILDING YOUR BUSINESS SKILLS

Putting the Buzz in Billing

Goal

To encourage you to think about the advantages and disadvantages of using an online system for handling accounts receivable and accounts payable electronically.

Method

Step 1

As the CFO of a Midwestern utility company, you are analyzing the feasibility of switching to a totally electronic bill-paying system. You decide to discuss the ramifications of the choice with three associates (choose three classmates to take on these roles). Your discussion requires that you research existing electronic payment systems. Specifically, using online and library research, you must find out as much as you can about the electronic bill-paying systems developed by Visa, Intuit, IBM, and the Checkfree Corporation.

Step 2

After you have researched this information, brainstorm the advantages and disadvantages of switching to an electronic system.

FOLLOW-UP QUESTIONS

1. What cost savings are inherent in the electronic system for both your company and its customers? In your answer, consider such costs as handling, postage, and paper.
2. What consequences would your decision to adopt an electronic system have on others with whom you do business, including manufacturers of electronic processing equipment, the U.S. Postal Service, and banks?
3. Switching to an electronic system would mean a large capital expense for new computers and software. How could analyzing the company's income statement help you justify this expense?
4. How are consumers likely to respond to paying bills electronically? Are you likely to get a different response from individuals than you get from business customers?

EXERCISING YOUR ETHICS: INDIVIDUAL EXERCISE

Give and Take with Accounting Clients

The Situation

CPAs rely on access to private information from clients for preparing financial documents. As professionals, accountants also charge fees for their services. Occasionally, however, the obligations of both parties become blurred when disputes arise, causing strained client-CPA relationships.

The Dilemma

Aaron Ault delivered original expense and income records so that his CPA, Katrina Belinski, could prepare financial statements for Ault's small business firm. Three months later, Katrina delivered the completed financial statements together with a fee for services to Ault. Aaron was surprised at what he regarded as excessive fees in the accountant's invoice and refused to make payment. Katrina, in turn, refused Ault's request for return of his original documents until such time as Ault paid for services rendered.

Unable to retrieve his documents, Ault filed a complaint with the Professional Ethics Executive Committee of the AICPA. The charge was violation of Rule 501—Acts Discreditable. Upon hearing the case, a settlement agreement was reached between the AICPA and the accountant. Its stipulations included the following: (1) a two-year suspension of the accountant from membership in the AICPA, and (2) the accountant must complete the AICPA course entitled Professional Ethics, with a passing grade of 90 or above.

QUESTIONS TO ADDRESS

1 What are the ethical issues in this situation?
2 What are the basic arguments for and against Aaron Ault's position in this situation? For and against Katrina Belinski's position?
3 What do you think of the AICPA's ruling in this situation? What would you do if you were placed in the role of ethics representative for the AICPA?

EXERCISING YOUR ETHICS: TEAM EXERCISE

Confidentially Yours

The Situation

Accountants are often entrusted with private, sensitive information that should be used confidentially. In this exercise, you're encouraged to think about ethical considerations that might arise when an accountant's career choices come up against a professional obligation to maintain confidentiality.

The Dilemma

Assume that you're the head accountant in Turbatron, a large electronics firm that makes components for other manufacturing firms. Your responsibilities include preparing Turbatron's financial statements that are then audited for financial reporting to shareholders. In addition, you regularly prepare confidential budgets for internal use by managers responsible for planning departmental activities, including future investments in new assets. You've also worked with auditors and CPA consultants who assess financial problems and suggest solutions.

Now let's suppose that you're approached by another company, Electroblast, one of the electronics industry's most successful firms, and offered a higher-level position. If you accept, your new job will include developing Electroblast's financial plans and serving on the strategic planning committee. Thus, you'd be involved not only in developing strategy but also in evaluating the competition, perhaps even using your knowledge of Turbatron's competitive strengths and weaknesses. Your contractual commitments with Turbatron do not bar you from employment with other electronics firms.

Team Activity

Assemble a group of four to five students and assign each group member to one of the following roles:

- Head accountant (leaving Turbatron)
- General manager of Turbatron
- Shareholder of Turbatron
- Customer of Turbatron
- General manager of Electroblast (if your team has five members)

ACTION STEPS

1 Before hearing any of your group's comments on this situation, and from the perspective of your assigned role, are any ethical issues confronting the head accountant in this situation? If so, write them down.
2 Return to your group and reveal ethical issues identified by each member. Were the issues the same among all roles or did differences in roles result in different issues?
3 Among the ethical issues that were identified, decide as a group which one is most important for the head accountant. Which is most important for Turbatron?
4 What does your group finally recommend be done to resolve the most important ethical issue(s)?
5 What steps do you think Turbatron might take in advance of such a situation to avoid any difficulties it now faces?

VIDEO EXERCISE

MyBizLab

POPS DINER

Learning Objectives

The purpose of this video is to help you:

1 Understand the role of accounting and distinguish between financial and managerial accounting.
2 Describe the equation underlying the balance sheet and explain each of the components.
3 Explain the purpose of the income statement and the equation it represents.

Synopsis

POPS Diner is a relatively new business with iconic roots. Built on the legendary Route 66 as it passes through Oklahoma, POPS is a retail location selling over 600 kinds of soda. However, POPS is so much more. The ultra-modern building was designed by a nationally acclaimed architect and includes a 66 foot high soda bottle made of steel and LED lights. The site includes a gas station, restaurant, shake shop, gift shop, and convenience store, each embodying a 1950s design. While POPS is certainly unique, just like other businesses, the owners and managers rely upon their accounting system to provide information for making decisions within the business and to communicate results to interested parties outside POPS.

DISCUSSION QUESTIONS

1 Who are the potential users of POPS accounting information?
2 What is financial accounting? What types of reports are parts of the financial accounting function?
3 What is managerial accounting and how does it differ from financial accounting? How will managers at POPS use this information?
4 What is the basic equation underlying the balance sheet? Describe the major components of the balance sheet for POPS Diner.
5 What does the income statement reveal to users? Explain the major sections of the income statement for POPS Diner.

Online Exploration

POPS Diner's website (http://route66.com) is as unique at its location and marketing strategy. Click on the "About POPS" link and take a look at a few of the videos to get a better sense of POPS and its iconic brand. As a privately owned company, POPS doesn't have to disclose its financial statements to the general public. After gaining a better understanding about POPS, describe how managers at POPS might use ratio analysis to evaluate their operations.

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