**CHAPTER 15: UNDERSTANDING ACCOUNTING AND FINANCIAL STATEMENTS**

**Overview**

Accounting professionals prepare the financial information that organizations present in their annual reports. Whether you begin your career by working for a company or by starting your own firm, you need to understand what accountants do and why their work is so important in contemporary business.

This chapter begins by describing who uses accounting information. It discusses business activities involving accounting statements: financing, investing, and operations. It explains the accounting process, defines double-entry bookkeeping, and presents the accounting equation. We then discuss the development of financial statements from information about financial transactions. The methods of interpreting these statements and the roles of budgeting in planning and controlling a business are described next. The chapter concludes with a discussion of the development and implementation schedule of a uniform set of accounting rules for global business.

**Glossary of Key Terms**

**Accounting:** process of measuring, interpreting, and communicating financial information to enable people inside and outside the firm to make informed decisions

**Accounting cycle:** set of activities involved in converting information and individual transactions into financial statements

**Accounting equation:** formula that states that assets must equal liabilities plus owners’ equity

**Accrual accounting:** accounting method that records revenues and expenses when they occur, not necessarily when cash actually changes hands

**Asset:** anything of value owned or leased by a business

**Balance sheet:** statement of a firm’s financial positionon a particular date

**Budget:** a planning and controlling tool that reflects the firm’s expected sales revenues, operating expenses, and cash receipts and outlays.

**Double-entry bookkeeping:** process by which accounting transactions are recorded; each transaction must have an offsetting transaction.

**Financial Accounting Standards Board (FASB): an** organization responsible for evaluating, setting, or modifying GAAP in the United States

**Foreign Corrupt Practices Act:** federal law that prohibits U.S. citizens and companies from bribing foreign officials in order to win or continue business

**Generally accepted accounting principles (GAAP):** principles that encompass the conventions, rules, and procedures for determining acceptable accounting and financial reporting practices at a particular time

**Income statement:** financial record summarizing a firm’s financial performance in terms of revenues, expenses, and profits over a given time period, say, a quarter or a year

**International Accounting Standards Board (IASB):** organization established in 1973 to promote worldwide consistency in financial reporting practices

**International Financial Reporting Standards (IFRS):** standards and interpretations adopted by the IASB

**Liability:** anything owed to creditors—the claims of a firm’s creditors

**Owners’ equity:** the owner’s initial investment in the business plus profits that were not paid out to owners over time in the form of cash dividends

**Public accountant:** accountant who provides accounting services to individuals or business firms for a fee

**Statement of cash flows:** statement showing the sources and uses of cash during a period of time

**Statement of owners’ equity:** record of the change in owners’ equity from the end of one fiscal period to the end of the next

**Learning Objective 1: Discuss the users of accounting information.**

*Accountants measure, interpret, and communicate financial information to parties inside and outside the firm to support improved decision making. Accountants gather, record, and interpret financial information for management. They also provide financial information on the status and operations of the firm for evaluation by outside parties, such as government agencies, stockholders, potential investors, and lenders. Accounting plays key roles in financing activities, which help start and expand an organization; investing activities, which provide the assets it needs to continue operating; and operating activities, which focus on selling goods and services and paying expenses incurred in regular operations.*

**Annotated Lecture Outline**

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| **Opening Vignette:**  **BKD LLP: A 21st Century Accounting Firm**  BKD LLP is one of the top ten U.S. CPA and advisory firms. BKD provides a wide range of accounting and audit services, helping corporate clients with mergers and acquisitions, sales, risk management, employee benefit plans, management buyouts, IPOs, and other financing operations. It advises individual clients on wealth planning, investments, and estate planning, and it also operates the BKD Foundation, a non-profit arm offering volunteer hours and millions in financial support to charitable organizations in local communities from Arkansas to Texas. |  |
| **USERS OF ACCOUNTING INFORMATION** |  |
| * 1. *Accounting* is the process of measuring, interpreting, and communicating financial information to enable people inside and outside the firm to make informed decisions. | PowerPoint Slide 3 |
| 1. Users of accounting information | Figure 15.1 Users of Accounting Information |
| * 1. People both inside and outside a firm rely on accounting information to help them make business decisions. |  |
| * 1. Managers are the major users of accounting information, because it helps them plan and control daily and long-range operations. | *Lecture Enhancer: How might managers use accounting information to help control daily operations?* |
| * 1. Business owners and boards of directors also rely on accounting data to determine how well managers are operating the organizations. |  |
| * 1. Union officials use accounting data in contract negotiations. | *Lecture Enhancer: Why would accounting information be useful to a union in its negotiations?* |
| * 1. Employees refer to accounting data as they monitor their firms’ productivity and profitability performance. |  |
| 1. Employees |  |
| * 1. *Open book management* refers to sharing sensitive financial information with employees and teaching them how to understand and use financial statements. | PowerPoint Slide 4 |
| * 1. Viewing financial information helps them understand how their work contributes to company success. | *Lecture Enhancer: What are some possible drawbacks to practicing open book management?* |

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| 1. Outside investors and government agencies |  |
| * 1. Outsiders use financial data to evaluate investment opportunities. |  |
| * 1. Bankers use accounting information to evaluate a potential borrower’s financial soundness. |  |
| * 1. The Internal Revenue Service (IRS) and state tax agencies use it to determine a company’s tax liability. |  |
| 1. **Business Activities Involving Accounting** | PowerPoint Slide 5 |
| * 1. Accounting plays a key role in three areas: |  |
| * + 1. *Financing activities* provide necessary funds to start and expand a business. |  |
| * + 1. *Investing activities* offer valuable assets needed to run a business. | *Class Activity:*  *Ask students how accounting supports a company’s investing activities.* |
| * + 1. *Operating activities* focus on selling goods and services while also considering expenses as key elements of sound financial management. |  |
| * 1. All organizations, profit-oriented and not-for-profit, perform these activities. |  |

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Assessment Check Answers

**1.1 Define *accounting*.**

*Accounting is the process of measuring, interpreting, and communicating financial information in a way that describes the status and operation of an organization and aids in decision making.*

**1.2 Who uses accounting information?**

*Managers of all types of organizations use accounting information to help them plan, assess performance, and control daily and long-term operations. Outside users of accounting information include government officials, investors, creditors, and donors.*

**1.3 What are the three business activities that involve accounting?**

*The three activities involving accounting are financing, investing, and operating activities.***Learning Objective 2: Describe accounting professionals.**

*Public accountants provide accounting services to other firms or individuals for a fee. They are involved in such activities as auditing, tax return preparation, management consulting, and accounting system design. Management accountants collect and record financial transactions, prepare financial statements, and interpret them for managers in their own firms. Government and not-for-profit accountants perform many of the same functions as management accountants, but they analyze how effectively the organization or agency is operating, rather than its profits and losses.*

**Annotated Lecture Outline**

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| **ACCOUNTING PROFESSIONALS** | PowerPoint Slide 6 |
| 1. **Public Accountants** |  |
| * 1. *Public accountants* provide accounting services to individuals or firms for a fee. |  |
| * 1. Basic services to clients: |  |
| * + 1. auditing, or examining, financial records |  |
| * + 1. tax preparation, planning, and related services |  |
| * + 1. management consulting |  |
| * 1. Public accounting firms have come under sharp criticism for providing management consulting services to many of the same firms they audited. | *Lecture Enhancer: What situation could result when an accounting firm also provides consulting services to a client?* |
| * 1. Legislation limits the types of consulting services auditors can provide as a result of scandals and bankruptcies. | *Lecture Enhancer: In what way might providing consulting services affect the auditing service of a public accounting firm?* |
| * 1. A growing number of public accountants are also certified as forensic accountants. | Hit & Miss: **Forensic Accountants: Fraud Busters** |
| * 1. *Certified public accountants (CPAs)* meet specified educational and experiential requirements and have passed a  comprehensive examination on accounting theory and practice. |  |
| 1. Other accountants carry the title certified management accountant, certified fraud examiner, or certified internal auditor. |  |
| 1. **Management Accountants** | *Lecture Enhancer: Compare and contrast the role of a management accountant with that of a public accountant.* |
| * 1. A *management accountant* collects and records financial transactions, prepares financial statements used by the firm’s managers in decision making, and provides answers to many important questions such as: |  |
| * + 1. Where is the company going? |  |
| * + 1. What opportunities await it? |  |
| * + 1. Do certain situations expose the company to excessive risk? |  |
| * + 1. Does the information system provide detailed and timely information to all management levels? |  |

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| * 1. Amanagement accountant often specializes in cost accounting, internal auditing, or tax accounting. | *Class Activity: Discuss how students could pursue a career in cost accounting, including the types of courses they might take to acquire needed skills.* |
| * 1. Some management accountants achieve a *certified management accountant (CMA)* designation through experience and passing a comprehensive examination. |  |
| * 1. Management accountants are usually involved in the development and enforcement of organizational policies. |  |
| 1. **Government and Not-for-Profit Accountants** |  |
| * 1. Government accountants and those who work for not-for-profit organizations perform professional services similar to those of management accountants. |  |
| * 1. Accountants in these sectors concern themselves primarily with determining how efficiently the organizations accomplish their objectives. | *Lecture Enhancer: Why might financial information be particularly important to a not-for-profit as opposed to a for-profit firm?* |

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Hit & Miss:

Forensic Accountants: Fraud Busters

**Summary**

Forensic accounting is accounting performed in preparation for legal review. Forensic accountants don’t simply accept a company’s numbers at face value—they are crime fighters. People who work in this growing field investigate such white-collar crimes as business fraud, improper financial reporting, and illegal investment schemes.

**Questions for Critical Thinking**

**1. Describe how a shift in the economy has created a new career path for accounting students.**

*Two important changes have occurred in the economy that provided a real need for forensic accounting. The first is the continuing shift of our economy to a service-based economy from a goods-producing economy. This has been accompanied by the tremendous use of the Internet for e-commerce and private data collection. In turn, this has provided a rich environment for hackers to illegally mine data and create illegal transactions. Forensic accounting is needed to respond to these ongoing threats and crimes. Also, as the economy has suffered a downturn, fraud and cheating becomes more likely from unethical individuals who may have access and authority to transactions and funds.*

**2. How might forensic accounting change the world of business?** *Forensic accounting may become much like home security systems. The knowledge that a company has a strong staff of forensic accountants may in itself serve as a disincentive to crime. Also, this area opens up many career opportunities in a wide spectrum of specializations.*

Assessment Check Answers

**2.1 List the three services offered by public accounting firms.**

*The three services offered by public accounting firms are auditing, management consulting, and tax services.*

**2.2 What tasks do management accountants perform?**

*Management accountants work for the organization and are responsible for collecting and recording financial transactions, and preparing and interpreting financial statements.*

**Learning Objective 3: Identify the foundation of the accounting system.**

*The foundation of the accounting system in the United States is GAAP (generally accepted accounting principles), a set of guidelines or standards that accountants follow. There are four basic requirements to which all accounting rules should adhere: consistency, relevance, reliability, and comparability. The Financial Accounting Standards Board (FASB), an independent body made up of accounting professionals, is primarily responsible for evaluating, setting, and modifying GAAP. The U.S. Securities and Exchange Commission (SEC) also plays a role in establishing and modifying accounting standards for public companies, firms whose shares are traded in the financial markets.*

**Annotated Lecture Outline**

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| **THE FOUNDATION OF THE ACCOUNTING SYSTEM** | PowerPoint Slide 7 |
| 1. *Generally accepted accounting principles (GAAP)* are the standards designed to provide reliable, consistent, and unbiased financial information. |  |
| * 1. They encompass the conventions, rules, and procedures considered to be acceptable accounting practices at a particular time. |  |
| * 1. GAAP standards are based on consistency, relevance, reliability, and comparability. | *Lecture Enhancer: Are the GAAP standards sufficient? Why or why not?* |
| 1. In the United States, the *Financial Accounting Standards Board (FASB)* is primarily responsible for evaluating, setting, or modifying GAAP. |  |

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| 1. The U.S. Securities and Exchange Commission (SEC) is the chief federal regulator of the financial markets, but the accounting industry has the statutory authority to establish financial accounting and reporting standards for publicly held companies. |  |
| 1. Financial Accounting Foundation—an organization made up of members of many different professional groups—actually appoints the members of FASB, although the SEC does have some input. |  |
| * 1. The Sarbanes-Oxley Act (SOX) created the Public Accounting Oversight Board to set audit standards, investigate, and sanction accounting firms that certify the books of publicly traded firms. |  |
| * + 1. Members of the Public Accounting Oversight Board are appointed by the SEC. |  |
| * + 1. Senior executives must personally certify that the financial information reported by the company is correct. | *Lecture Enhancer: Why is it important that senior executives, and not simply a firm’s accountants, verify this information themselves?* |
| 1. The *Foreign Corrupt Practices Act* is a federal law that prohibits U.S. citizens and companies from bribing foreign officials in order to win or continue business. |  |

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Assessment Check Answers

**3.1 Define *GAAP*.**

*GAAP stands for generally accepted accounting principles and is a set of standards or guidelines that accountants follow in recording and reporting financial transactions.*

**3.2 What are the four basic requirements to which all accounting rules must adhere?**

*The four basic requirements to which all accounting rules must adhere are consistency, relevance, reliability, and comparability.*

**3.3 What is the role played by the FASB?**

*The Financial Accounting Standards Board (FASB) is an independent body made up of accounting professionals and is primarily responsible for evaluating, setting, and modifying GAAP.*

**Learning Objective 4: Outline the steps in the accounting cycle.**

*The accounting process involves recording, classifying, and summarizing data about transactions and then using this information to produce financial statements for the firm’s managers and other interested parties. Transactions are recorded chronologically in journals, posted in ledgers, and then summarized in accounting statements. Today, much of this activity takes place electronically. The basic accounting equation states that assets (what a firm owns) must always equal liabilities (what a firm owes creditors) plus owners’ equity. This equation also illustrates double-entry bookkeeping, the process by which accounting transactions are recorded. Under double-entry bookkeeping, each individual transaction must have an offsetting transaction.*

**Annotated Lecture Outline**

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| THE ACCOUNTING CYCLE | PowerPoint Slide 8 |
| * 1. Accounting deals with the financial transactions between a firm and its employees, customers, suppliers, owners, bankers, and government agencies. |  |
| * 1. The *accounting cycle* refers to the procedure by which accountants convert data about individual transactions to financial statements. |  |
| * 1. The main activities involved in the accounting cycle include recording, classifying, and summarizing. | Figure 15.2 The Accounting Cycle  *Lecture Enhancer: Think about your everyday financial transactions. Can you record, classify, and summarize them?* |

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| 1. **The Accounting Equation** | PowerPoint Slide 9 |
| * 1. Three fundamental terms appear in the accounting equation: assets, liabilities, and owners’ equity. |  |
| * 1. An *asset*is anything of value owned or leased by a business. |  |
| * + 1. Tangible assets include equipment, buildings, and inventories. |  |
| * + 1. Intangible assets include patents and trademarks. | *Lecture Enhancer: What are some additional examples of intangible assets?* |
| * 1. *Liabilities* are claims against a firm’s assets by a creditor. |  |
| * + 1. The claims of creditors include accounts payable, notes payable, or long-term debt. |  |
| * + 1. Wages and salaries owed to employees also represent liabilities. |  |
| * 1. *Owners’ equity* represents the owners’ initial investment in the business plus profits that were not paid to owners over time in the form of cash dividends. |  |
| * + 1. A strong owners’ equity is considered evidence of a firm’s financial strength and stability. |  |
| * 1. The *accounting equation* states that assets must equal liabilities plus owners’ equity. |  |
| * + 1. Assets = Liabilities + Owners’ equity |  |
| * + 1. The equation shows the firm’s financial position at any point in time. |  |
| * 1. *Double-entry bookkeeping* is the process by which accounting transactions are entered; each transaction has an offsetting transaction. |  |
| * 1. The relationship expressed by the accounting equation underlies development of the firm’s financial statements: the balance sheet, the income statement, and the statement of owners’ equity. |  |
| 1. **The Impact of Computers and the Internet on the Accounting Process** | PowerPoint Slide 10 |
| * 1. Computers simplify the accounting process by automating data entry and calculations. | *Lecture Enhancer:*  *In what ways have computers simplified your tax preparation, filing, and paperwork?* |
| * 1. Available accounting software products are customized for businesses of different sizes. | *Class Activity: Discuss what aspects of payroll accounting allowed this area to be outsourced earlier than most other accounting applications.* |
| * 1. Several software producers offer Web-based accounting products designed for small and medium-sized businesses. | Going Green:  **KPMG’s Award-Winning Green IT** |

**Notes: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Going Green**

KPMG’s Award-Winning Green IT

**Summary**

If you think of accountants as “paper pushers,” the New York-based audit, tax, and consulting firm KPMG wants you to think again. Since 2007 the Big Four company has reduced paper consumption 33 percent. In fact, it was recently singled out by *Computerworld* for outstanding performance in reducing its energy consumption in IT and other operations.

KPMG has reduced carbon use by almost 25 percent and non-recycled waste by over 50 percent in the last few years. Using IT to almost double its use of videoconferencing technology, it eliminated more than $2 million a year in travel costs in a single year. Under its aggressive new five-year goals for reducing its carbon footprint, KPMG will move more operations to cloud computing systems, purchase greener forms of energy by installing solar panels, and seek Leadership in Energy and Environment Design (LEED) certification for any new construction it undertakes.

Says the firm’s head of operations services, “We’re committed to affecting change in our business operations to minimize the firm’s environmental profile.”

**Questions for Critical Thinking**

1. **KPMG says it will continue “to focus on environmental stewardship in the communities where we operate.” What impact on its communities can KPMG’s actions have?**

*(Students answer individually.)*

1. **KPMG’s green planning includes implementing flexible work arrangements. What is the environmental payoff of this step?**

*(Students answer individually.)*

Assessment Check Answers

**4.1 List the steps in the accounting cycle.**

*The accounting cycle involves the following steps: recording transactions, classifying these transactions, summarizing transactions, and using the summaries to produce financial statements.*

**4.2 What is the accounting equation?**

*The accounting equation states that assets (what a firm owns) must always equal liabilities (what a firm owes) plus owners’ equity. Therefore, if assets increase or decrease, there must be an offsetting increase or decrease in liabilities, owners’ equity, or both.*

**4.3 Briefly explain double-entry bookkeeping.**

*Double-entry bookkeeping means that every transaction must have an offsetting transaction.*

**Learning Objective 5: Explain financial statements.**

*The balance sheet shows the financial position of a company on a particular date. The three major classifications of balance sheet data are the components of the accounting equation: assets, liabilities, and owners’ equity. The income statement shows the results of a firm’s operations over a specific period. It focuses on the firm’s activities—its revenues and expenditures—and the resulting profit or loss during the period. The major components of the income statement are revenues, cost of goods sold, expenses, and profit or loss. The statement of owners’ equity shows the components of the change in owners’ equity from the end of the prior year to the end of the current year. Finally, the statement of cash flows indicates a firm’s cash receipts and cash payments during an accounting period. It outlines the sources and uses of cash in the basic business activities of operating, investing, and financing.*

**Annotated Lecture Outline**

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| **FINANCIAL STATEMENTS** |  |
| * 1. Financial statements provide managers with information for evaluating an organization’s ability to meet current obligations and needs, its profitability, and its overall financial health. |  |
| * 1. The balance sheet, income statement, statement of owners’ equity, and statement of cash flows provide a foundation on which managers can base their decisions. |  |
| * 1. Public companies are required to report their financial statements at the end of each three-month period, as well as at the end of each fiscal year. | *Lecture Enhancer: Why is it important that public companies report their statements frequently?* |

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| * 1. Annual statements must be examined and verified by the firm’s outside auditors. | Solving an Ethical Controversy:  Should Whistleblowers Be Rewarded?  *Class Activity: Discuss Bernie Madoff’s Ponzi scheme and the SEC whistleblower’s attempts to expose it, which were ignored.* |
| 1. **The Balance Sheet** | PowerPoint Slide 11 |
| * 1. The *balance sheet* is a statement of a firm’s financial position on a particular date. |  |
| * 1. The balance sheet follows the accounting equation: | PowerPoint Slide 12  Figure 15.3 Belle’s Fine Coffees Belle’s Fine Coffees Balance Sheet (Fiscal Year, Ending December 31) |
| * + 1. On the left side are assets of the firm shown in descending order of liquidity. |  |
| * + 1. On the right side are claims against the firm (liabilities and owners’ equity) listed in the order in which they are due. |  |
| * + 1. The difference between assets and liabilities is owners’ equity. | *Lecture Enhancer: What does the balance sheet show about the status of a firm? What does a balance sheet not tell about a firm?* |

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| 1. **The Income Statement** | PowerPoint Slide 13 |
| * 1. An *income statement* is a financial record of a firm’s revenues, expenses, and profits over a longer period of time, usually a quarter or year. | PowerPoint Slide 14  Figure 15.4 Belle’s Fine Coffees Income Statement (Fiscal Year Ending December 31) |
| * + 1. It represents the flow of resources that reveals the performance of the organization over a specific time period. |  |
| * + 1. It helps decision makers focus on overall revenues and the costs involved in generating these revenues. |  |
| * + 1. It provides the data needed to calculate financial ratios to plan and control activities. |  |
| * 1. An income statement, also called a *profit-and-loss statement* (P&L), begins with total money coming in and subtracts all costs. |  |
| * 1. Typical expenses include the cost of producing the goods or services, operating expenses, interest, and taxes. | *Lecture Enhancer:*  *If the expenses of a company are increasing from year to year, what might that indicate?* |
| * 1. After these have been subtracted, the remaining net income may be distributed (to owners, stockholders, proprietors, or partners) or reinvested. |  |

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| * 1. The *bottom line* of the income statement reflects the net income after taxes. | *Class Activity:*  *Which industries generally have the highest net income? Lowest?* |
| 1. **Statement of Owners’ Equity** | PowerPoint Slide 15 |
| a. The *statement of owners’,* or shareholders’, *equity* is designed to show the components of the change in equity from the end of one fiscal year to the end of the next. | Figure 15.5 Belle’s Fine Coffees Simplified Statement of Owners’ Equity (Fiscal Year, Ending December 31) |
| b. It uses information from the balance sheet and income statement. | PowerPoint Slide 16 |
| i. It begins with the amount of equity on the balance sheet at the end of the prior year. |  |
| ii. Net income is added, and cash dividends paid to owners are subtracted (found on the income statement for the current year). |  |
| * + 1. The new amount of owners’ equity is then reported on the balance sheet for the current year. |  |
| 1. **Statement of Cash Flows** | PowerPoint Slide 17 |
| * 1. The *statement of cash flows* provides investors and creditors with relevant information about a firm’s cash receipts and cash payments for its operations, investments, and financing during an accounting period. | PowerPoint Slide 18  Figure 15.6 Belle’s Fine Coffees Statement of Cash Flows (Fiscal Year Ending, December 31) |

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| i. It provides information about a firm’s cash receipts and cash payments for its operations, investments, and financing during an accounting period. |  |
| ii. Public companies are required to publish these, and commercial lenders often require a borrower to submit them. |  |
| * 1. *Accrual accounting* is an accounting method that records revenue and expenses when they occur, not necessarily when cash actually changes hands. |  |
| * 1. There can be differences between what is reported (as sales, expenses, and profits) and the amount of cash that actually flows into and out of a business. |  |
| * 1. Companies depreciate fixed assets—such as machinery and buildings—over a specified period of time, meaning that they systematically reduce the value of the asset. |  |
| i. Depreciation is reported as an expense on the income statement but does not involve any actual cash. | *Class Activity:*  *Ask students if depreciation expense is a cash expense (reduction of cash).* |
| ii. The net income understates the amount of cash, so depreciation is added back to the net income to obtain cash flow. |  |

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| * 1. *Cash flow*—the funding needed for continued daily operation—is the lifeblood of every organization. |  |
| i. Inadequate cash flow is a reason for many business failures. |  |

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Assessment Check Answers

**5.1 List the four financial statements.**

*The four financial statements are the balance sheet, the income statement, the statement of owners’ equity, and the cash flow statement.*

**5.2 How is the balance sheet organized?**

*Assets (what a firm owns) are shown on one side of the balance sheet and are listed in order of convertibility into cash. On the other side of the balance sheet are claims to assets, liabilities (what a firm owes), and owners’ equity. Claims are listed in the order in which they are due, so liabilities are listed before owners’ equity. Assets always equal liabilities plus owners’ equity.*

**5.3 Define *accrual accounting.***

*Accrual accounting recognizes revenues and expenses when they occur, not when cash actually changes hands. Most companies use accrual accounting to prepare their financial statements.*

**Learning Objective 6: Discuss financial ratio analysis.**

*Liquidity ratios measure a firm’s ability to meet short-term obligations. Examples are the current ratio and the quick, or acid test, ratio. Activity ratios, such as the inventory turnover ratio, accounts receivable turnover ratio, and the total asset turnover ratio, measure how effectively a firm uses its resources. Profitability ratios assess the overall financial performance of the business. The gross profit margin, net profit margin, and return on owners’ equity are examples. Leverage ratios, such as the total liabilities to total assets ratio and the long-term debt to equity ratio, measure the extent to which the firm relies on debt to finance its operations. Financial ratios help managers and outside evaluators compare a firm’s current financial information with that of previous years and with results for other firms in the same industry.*

**Annotated Lecture Outline**

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| **FINANCIAL RATIO ANALYSIS** | PowerPoint Slide 19 |
| * 1. *Ratio analysis* measures the firm’s liquidity, profitability, and reliance on debt financing, and the effectiveness of resource utilization. |  |
| * 1. Ratios assist managers by interpreting actual performance and making comparisons to what should have happened. |  |
| * 1. Ratios can be classified according to their specific purposes. |  |
| 1. **Liquidity Ratios** | PowerPoint Slide 20 |
| * 1. *Liquidity ratios* measure a firm’s ability to meet its short-term obligations when they must be paid. |  |

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| * + 1. Increasing liquidity avoids emergencies caused by the need to raise funds to repay loans. |  |
| * + 1. Decreasing liquidity may force a firm to choose between default and borrowing to pay its bills. |  |
| * 1. Two liquidity ratios: |  |
| * + 1. Current ratio looks at current assets vs. current liabilities. |  |
| * + 1. This measures the firm’s ability to pay its debts as they mature. |  |
| * + 1. Acid-test ratio, or quick ratio, compares quick assets, the most liquid current assets, against current liabilities. |  |
| * + 1. This ratio measures the firm’s ability to meet its debt payments on short notice. |  |
| 1. **Activity Ratios** | PowerPoint Slide 21 |
| * 1. *Activity ratios* measure the effectiveness of the firm’s use of resources. | *Class Activity:*  *Why would a decline in inventory turnover ratio several years in a row raise concern?* |
| * 1. *Inventory turnover* ratio indicates the number of times merchandise moves through a business. | *Lecture Enhancer: Provide examples of industries with low and high inventory turnover.* |
| * + 1. Inventory turnover rates can vary widely from industry to industry. |  |

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| * 1. If a company makes sales on credit, measuring *receivables turnover* can be useful; credit sales divided by average accounts receivable. | *Class Activity:*  *What types of companies might have very slow receivables turnover?* |
| * 1. *Total asset turnover indicates* how much in sales each dollar invested in assets generates. |  |
| 1. **Profitability Ratios** | PowerPoint Slide 22 |
| a. *Profitability ratios* measure the firm’s  ability to generate revenues in excess of expenses and operating costs. |  |
| b. They compare earnings with total sales or investments, and may reveal the effectiveness of management. |  |
| c. Profitability ratios: |  |
| * + 1. gross profit margin |  |
| * + 1. net profit margin |  |
| * + 1. return on assets |  |
| * + 1. return on equity |  |
| d. Profitability ratios should be evaluated in relation to profit forecasts, past performance, or industry averages. |  |
| **4. Leverage Ratios** | PowerPoint Slide 23 |
| * 1. *Leverage ratios* measure the extent to which the firm relies on debt financing. | *Lecture Enhancer:*  *Is a company with no debt leverage better than one with some leverage? Why or why not?* |

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| * 1. If management has assumed too much debt, problems may arise in meeting interest payments and repaying loans. |  |
| * 1. A firm needs to invest enough of its own money to avoid relying too much on borrowing, which can lead to bankruptcy. |  |
| * 1. Total liabilities to total assets ratio greater than 50 percent indicates that a firm is relying more on borrowed money than on owners’ equity. |  |

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Assessment Check Answers

**6.1 List the four categories of financial ratios.**

*The four categories of ratios are liquidity, activity, profitability, and leverage.*

**6.2 Define the following ratios:** current ratio, inventory turnover, net profit margin, **and** debt ratio.

*The current ratio equals current assets divided by current liabilities; inventory turnover equals cost of goods sold divided by average inventory; net profit margin equals net income divided by sales; the debt ratio equals total liabilities divided by total assets.*

**Learning Objective 7: Describe the role of budgeting.**

*Budgets are financial guidelines for future periods reflecting expected sales revenues, operating expenses, and cash receipts and outlays. They reflect management expectations for future occurrences and are based on plans that have been made. Budgets serve as important planning and controlling tools by providing standards against which actual performance can be measured. One important type of budget is the cash budget, which estimates cash inflows and outflows over a period of time.*

**Annotated Lecture Outline**

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| **BUDGETING** | PowerPoint Slide 24 |
| 1. A *budget* is a planning and controlling tool that reflects a firm’s expected sales revenue, operating expenses, and cash receipts and outlays. | *Lecture Enhancer: What are some items that you could include in your personal budget?* |
| * 1. It quantifies the firm’s plans for a specified future period. |  |
| * 1. The budget is a financial blueprint and can be thought of as a short-term financial plan. |  |
| 1. Budget preparation is frequently a time-consuming task that involves many people from various departments within the organization. | **Business Etiquette: Managing Travel Expenses** |
| * 1. The complexity of the budgeting process varies with the size and complexity of the organization. |  |
| * 1. The purpose of budgeting is to match income and expenses in a way that accomplishes objectives and correctly times cash inflows and outflows. |  |
| * 1. Because the accounting department is an organization’s financial nerve center, it provides much of the data for budget development. |  |
| * 1. Technology has streamlined the budgeting process with specialized software. |  |
| 1. One of the most important budgets prepared by firms is the *cash budget.* | PowerPoint Slide 25  Figure 15.7 Four-Month Cash Budget for Birchwood Paper Company |
| * 1. A cash budget tracks a firm’s cash inflows and outflows. | *Class Activity:*  *Ask students why sales might be difficult to estimate.* |
| * 1. It shows in which months the firm will need loans and in which it can repay. |  |
| * 1. It acts as a tangible standard for comparing actual cash inflows and outflows monthly. |  |

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Assessment Check Answers

**7.1 What is a budget?**

*A budget is a planning and control tool that reflects the firm’s expected sales revenues, operating expenses, cash receipts, and cash outlays.*

**7.2 How is a cash budget organized?**

*Cash budgets are generally prepared monthly. Cash receipts are listed first. They include cash sales as well as the collection of past credit sales. Cash outlays are listed next. These include cash purchases, payment of past credit purchases, and operating expenses. The difference between cash receipts and cash outlays is net cash flow.*

**Learning Objective 8: Outline international accounting practices.**

*One accounting issue that affects global business is exchange rates. An exchange rate is the ratio at which a country’s currency can be exchanged for other currencies. Daily changes in exchange rates affect the accounting entries for sales and purchases of firms involved in international markets. These fluctuations create either losses or gains for particular companies. The International Accounting Standards Board (IASB) was established to provide worldwide consistency in financial reporting practices and comparability of and uniformity in international accounting standards. It has developed International Financial Reporting Standards (IFRS). Many countries have already adopted IFRS, and the United States is in the process of making the transition to it.*

**Annotated Lecture Outline**

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| **INTERNATIONAL ACCOUNTING** | PowerPoint Slide 26 |
| * 1. Global firms must translate financial statements of the firm’s international affiliates, branches, and subsidiaries and convert data about foreign currency transactions to dollars. | Hit & Miss:  Behind the Olympus Accounting Scandal |
| * 1. Foreign currencies and exchange rates influence the accounting and financial reporting processes of firms operating internationally. | *Lecture Enhancer: What problems arise for American accounting firms doing business abroad?* |
| 1. **Exchange Rates** |  |
| * 1. An exchange rate is the ratio at which a country’s currency can be exchanged for other currencies. |  |

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| * 1. Currencies can be treated as goods to be bought and sold, and prices change daily due to supply and demand, so they can complicate accounting entries. | *Class Activity:*  *How could a decrease in the exchange rate of the US dollar relative to the Euro be positive for the export business of an American company?* |
| * 1. Accountants who deal with international transactions must appropriately record their firms’ foreign sales and purchases. |  |
| * 1. GAAP requires firms to make adjustments to their earnings that reflect changes in exchange rates. |  |
| 1. **International Accounting Standards** |  |
| * 1. The International Accounting Standards Committee (IASC) promotes worldwide consistency in financial reporting practices. |  |
| * 1. In 2001, it becamethe *International Accounting Standards Board (IASB)*. |  |
| * 1. *International Financial Reporting Standards (IFRS)* are the standards and interpretations adopted by the IASB. |  |
| * 1. To assist global investors, firms report financial information according to international accounting standards. |  |
| * 1. How does IFRS differ from GAAP? |  |
| 1. Under GAAP, plant, property, and equipment are reported on the balance sheet at the historical cost minus depreciation. |  |
| 1. Under IFRS, plant, property, and equipment are shown on the balance sheet at current market value. |  |
| 1. Many accounting experts believe that IFRS is overall less complicated than GAAP and more transparent. |  |

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Hit & Miss:

**Behind the Olympus Accounting Scandal** **Summary**

To conceal investment losses of almost $2 billion, top executives at Olympus, the Japanese camera and medical equipment maker, created dubious financial transactions and misled auditors for years. When Michael C. Woodford became CEO and grew suspicious, he arranged a new audit by PricewaterhouseCoopers that called Olympus’s management “rotten to the core.” In October 2011, Woodford was fired and left Japan.

The global media covered the accounting story extensively. Olympus’s share values dropped by half, board members and executives were forced to resign, and the company stood in danger of being delisted by the Tokyo Stock Exchange, which fined it $1.27 million for “falsifying financial records to conceal losses.” Those responsible face possible criminal charges.

Company funds remain missing. “We still don’t know what they were actually doing,” says Woodford. “There has never been any explanation that makes sense.”

**Questions for Critical Thinking**

1. **Olympus’s auditors, KPMG AZSA and Ernst & Young Nippon, questioned the shady transactions but were told a third party had found all in order. Were they correct not to act?**
2. **Olympus’s new president said, “We deeply regret that we have given a very negative impression to Japan and possibly the world.” What should Olympus do now?**

Assessment Check Answers

**8.1 How are financial statements adjusted for exchange rates?**

*An exchange rate is the ratio at which a country’s currency can be exchanged for other currencies. Fluctuations of exchange rates create either gains or losses for particular companies because data about international financial transactions must be translated into the currency of the country in which the parent company resides.*

**8.2 What is the purpose of the IASB?**

*The International Accounting Standards Board (IASB) was established to provide worldwide consistency in financial reporting practices and comparability and uniformity of international accounting rules. The IASB has developed the International Financial Reporting Standards (IFRS).***Answers to Review Questions**

**1. Define *accounting*. Who are the major users of accounting information?**

*Accounting is the practice of measuring, interpreting, and communicating financial information so people inside and outside a firm can make informed decisions and understand how well the firm is operating.*

*The major users of accounting information are leaders inside a firm (CEO, chief officers, and managers) and others outside the firm (potential investors, bankers and creditors, the IRS, state tax officials, and union officials).*

**2. What are the three major business activities in which accountants play a major role? Give an example of each.**

* *Financing activities provide necessary funds to start a business and eventually expand it (examples: creating a business plan, obtaining financing).*
* *Investing activities offer valuable assets and revenues needed to run a business (example: devising procedures for offering stock options).*
* *Operating activities focus on selling goods and services while also considering expenses as key elements of sound financial management (examples: balancing expenses with profits, reviewing P&L statements, issuing financial statements).*

**3. What does the term *GAAP* mean? Briefly explain the roles of the Financial Accounting Standards Board and the Securities and Exchange Commission.**

*Generally accepted accounting principles (GAAP) are the standards designed to provide reliable, consistent, and unbiased financial information. They encompass the conventions, rules, and procedures considered as acceptable accounting practices at a particular time*.

*It evaluates, sets, and modifies GAAP in the United   
States.*

*The role of the FASB is to monitor changing business conditions and enact new regulations or revise existing ones as needed, such as recent rulings on stock options, pension accounting, and financial reporting.*

*The U.S. Securities and Exchange Commission (SEC) is the chief federal regulator of the financial markets and accounting industry and has the statutory authority to establish financial accounting and reporting standards for publicly held companies.*

**4. What is double-entry bookkeeping? Give a brief example.**

*Double-entry bookkeeping is the process in which accounting transactions are recorded and checked, with each transaction having an offsetting transaction. It says that if a company increases one asset, another asset must decrease, a liability must increase, or owner’s equity must increase. So if a company uses cash to buy inventory, one asset (inventory) increases while another (cash) decreases.* *The opposite occurs with a decrease in an asset. For example, both the balance sheet and income statement are created from the double-entry bookkeeping system*.

**5. List the four major financial statements. Which financial statements are permanent and which are temporary?**

* *A firm’s balance sheet is a snapshot of its financial position on one certain date, showing exactly what a company owns (assets), what it owes (liabilities), and what its initial investment and profits are (owners’ equity) at that moment.*
* *An income statement (also called a profit-and-loss statement, or P&L) is a record of a firm’s revenues, expenses, and profits over time, usually a quarter or a year, showing total money that came in minus all costs related to producing that revenue.*
* *The statement of owners’ equity shows the components of the change in equity from the end of one fiscal year to the end of the next.*
* *A statement of cash flows shows a firm’s cash receipts and cash payments for its operations, investments, and financing over a certain period, plus its sources of cash and use of cash.*

*Of the four financial statements, only the balance sheet is considered to be a permanent statement; its amounts are carried over from year to year. The income statement, statement of owners’ equity, and statement of cash flows are considered temporary because they are closed out at the end of each year.*

**6. What is the difference between a current asset and a long-term asset? Why is cash typically listed first on a balance sheet?**

* *Current assets are the total of a firm’s cash equivalents, short-term investments, accounts receivable, and inventory at a particular time. Current ratio looks at current assets versus current liabilities, measuring the firm’s ability to pay its debts as they mature*.
* *Long-term assets are the value of a company’s property, equipment, and other* [*capital assets*](http://www.investorwords.com/697/capital_assets.html) *expected to be useable for more than a year, minus* [*depreciation*](http://www.investorwords.com/1416/depreciation.html)*.*

*Cash is listed first because the balance sheet needs to show the relationship (balance) between assets and the total of liabilities plus equity. So it starts out by documenting what the firm owns—its assets, or cash.*

**7. List and explain the major items found on an income statement.**

*An income statement is a financial record summarizing a firm’s financial performance in terms of revenues, expenses, and profits over a given time period, say, a quarter or a year. It helps decision makers focus on overall revenues and the costs involved in generating these revenues.*

*An income statement (sometimes called a profit-and-loss, or P&L, statement) begins with total sales or revenues generated during a year, quarter, or month. Subsequent lines then deduct all of the costs related to producing the revenues. Typical categories of costs include those involved in producing the firm’s goods or services, operating expenses, interest, and taxes. After all of them have been subtracted, the remaining net income may be distributed to the firm’s owners (stockholders, proprietors, or partners) or reinvested in the company as retained earnings. The final figure on the income statement—net income after taxes—is the so-called bottom line.*

**8. What is accrual accounting? Give an example of how accrual accounting affects a firm’s financial statements.**

*Accrual accounting recognizes revenues and costs when they occur, not when actual cash changes hands.* *One example is depreciation. There can be differences between what is reported (as sales, expenses, and profits) and the amount of cash that actually flows into and out of a business. What a firm reports as net income actually understates the amount of cash it took in, so depreciation is added back to the net income to obtain cash flow.*

**9. List the four categories of financial ratios and give an example of each. What is the purpose of ratio analysis?**

* *Liquidity ratios measure a firm’s ability to meet its short-term obligations when they must be paid (examples: current ratio, acid-test ratio).*
* *Activity ratios measure the effectiveness of the firm’s use of resources (examples: inventory turnover ratio, total asset turnover).*
* *Profitability ratios measure the firm’s ability to generate revenues in excess of expenses and operational costs (examples: gross profit margin, net profit margin, return on assets, return on equity).*
* *Leverage ratios measure the extent to which the firm relies on debt financing (example: a firm’s percentage of assets acquired using borrowed funds).*

*Ratio analysis gives managers, outside investors, and creditors information concerning the financial health of a company. This analysis allows a company to compare its financial information with that of previous years and with that of similar firms.*

**10. What is a cash budget*?* Briefly outline what a simple cash budget might look like*.***

*A cash budget tracks a firm’s cash inflows and outflows, usually on a monthly basis, showing in which months the firm will need loans and in which it can invest*.

*A simple cash budget lists sales and incoming revenue, purchases and expenses, and net cash flow. It adds up total cash inflow, total cash outflow, and then summarizes beginning cash balance and ending cash balance. The final balance is important because it determines whether the firm should borrow or spend.*

**Projects and Teamwork Applications**

1. Have students talk about what they learned from a partner at a local public accounting firm. Ask them about this individual’s educational background, professional experience, and specialties. What kind of workload and responsibilities are involved in this position? What is a typical day like?

2. Have students report on the type of U.S. firm they imagined in choosing one that has extensive European operations. Which types of financial statements, and parts of each type, would be affected by exchange rates? Have them discuss the effect that the euro might have on this process.

3. What can be learned from a firm’s financial statements when thinking about buying its stock? Ask students to share what they learned by investigating a company’s financial statements. Which companies did they explore? Did the financial statements encourage or discourage them from buying? Have them explain the reasons for their decision based on the totals seen in the company’s financial statements.

4. Have students share the improvements they would make on the organization’s financial statements. What types of statements would they suggest creating? What reasons did they have for formulating better-quality statements that might convince potential donors to get involved?

5. Ask students to share their personal cash budgets for next month. Did they take into account all cash inflows and cash outflows? Did they feel better informed about their financial situation after going through this process? What changes might they make in months to come based on their results?

Web Assignments

1. **International Accounting Standards Board (IASB).** The IASB is responsible for setting and modifying international accounting rules. Go to the IASB’s Web site (<http://www.iasb.org>) and click on “about us.” Print out the material and bring it to class to participate in a class discussion on the IASB.
2. **Certified management accountant (CMA).** As noted in the chapter, managerial accountants often seek CMA certifications. Visit the Web site of the Institute of Management Accountants (<http://www.imanet.org>). Click on “CMA Certification” and then “Become a CMA.” What are the educational and experiential requirements for obtaining a CMA? How many exams does a CMA candidate have to pass? What do these exams cover?
3. **Financial reporting requirements.** This chapter discussed the financial reporting requirements of public companies in the United States. Public companies are those whose shares are traded on a stock exchange. Visit the Web site listed below. Type in the name of a public company and then click on “financials” to view the firm’s current financial statements. Prepare a brief report comparing those statements to the ones shown in the chapter.  
   <http://www.google.com/finance>

*Note: Internet Web addresses change frequently. If you don’t find the exact sites listed, you may need to access the organization’s home page and search from there or use a search engine such as Bing or Google.*

Case 15.1

**Shoeboxed to the Rescue**

There’s no lack of great software to help you with your accounting, your recordkeeping, and your tax preparation. If only you could easily get your collection of little paper receipts into one of those programs.

But now you can. Shoeboxed Inc., a small North Carolina company, will extract data from your receipts, business cards, emails, and paper documents, and organize them into an online account ready for feeding into your favorite financial-management program. Users can email, upload, photograph, or scan their information; Shoeboxed even provides prepaid envelopes for those who prefer snail-mail.

“Shoeboxed set out to be (and has become) the bridge between the pile of physical receipts on your desk and an organized and online IRS-accepted archive of your financial information that is accessible at your fingers anytime, anywhere,” said the company’s marketing manager.

With 100,000 customers in 100 countries, Shoeboxed is committed to growth and is cementing partnerships with companies like Hewlett Packard to use web-enabled printers for scanning information directly to their Shoeboxed accounts.

“We want to be in every small business, that’s our goal,” says founder Taylor Mingos. “We are partnering aggressively.”

**Answers to Questions for Critical Thinking:**

1. **Shoeboxed users can decide whether to get their receipts back or have the firm shred them. What do you recommend?**

*(Students answer individually.)*

1. **Are there any disadvantages of a service like Shoeboxed? If so, what are they?**

*Yes. If employees are not well-trained on how to use the software, problems could arise. If there is employee turnover, new employees would have to be trained, and until they knew the software well, there would be the possibility for errors entered into the system. Even with training, employees make data entry errors.*

Case 15.2

BDO Seidman: Growing with the 20th Century and Beyond

**Answers to Questions for Critical Thinking:**

1. **What historic and economic factors do you think might have contributed to the growth and expansion of the accounting industry, and Seidman’s firm, from the early 20th century to today?**

*The accounting industry has grown because of the bankruptcies of companies, greed on Wall Street, fraud, and the huge losses faced by investors. In the 1980s the United States faced the savings and loan crisis, then came the failure of giant companies like Enron. In 2008, the subprime mortgage problem that was laid bare by a decline in home values developed into a much broader credit crisis that toppled giant banks and financial institutions.*

1. **What advantages does BDO Seidman LLP enjoy in belonging to a large, international group?** *BDO Seidman enjoys many advantages in belonging to a large international group. This enables BDO Seidman to better understand and operate in countries with varying languages, business practices, laws, and cultures globally. Furthermore, it provides the firm with higher credibility that should result in more accounting and auditing work and revenues worldwide, in a more seamless, cost-effective, and efficient manner. In turn, multinational companies will look at BDO Seidman as a viable option for their needs.*

**CHAPTER 15: COLLABORATIVE LEARNING EXERCISES**

# **1 - Open Book Management**

Learning Objective: 1

Purpose:

To highlight the pros and cons of sharing financial information with employees

Background:

The SEC requires publicly held companies to disclose all of their financial statements, but a growing number of privately held companies are also sharing complete financial information with their employees. This exercise is designed to showcase the advantages and disadvantages of this approach, by asking students to develop the arguments for and against sharing information.

Relationship to Text:

Learning Objective 1 – Users of Accounting Information

Estimated Class Time:

About 20 minutes

Preparation/Materials:

None needed

Exercise:

Divide your class into groups of 3 to 5 students and announce that each group represents a medium-sized, privately held company in the crowded, competitive video game development industry. Ask each group to choose a CEO, a director of human resources, and a director of accounting. (If the groups are larger than three students, they can work in pairs.)

The director of human resources believes that the company should share financial information with all employees, while the director of accounting believes that this would be a serious mistake. Give the groups five minutes to develop their arguments (the CEOs should use this time to decide where they stand and why). Then, give each director two minutes to present his or her case to the CEO. After hearing both sides, the CEO must decide a course of action.

Ask by a show of hands how many CEOs decided to share financial information. How many changed their minds after hearing the arguments from their directors?

Recruit two volunteers from separate groups to present their arguments to the class. When each finishes, ask the other groups to contribute additional arguments. Close with a full class vote on whether they would share full financial information with employees if they were the CEO.

# **2 - Ethical Accounting**

Learning Objective: 3

Purpose:

To discuss and promote ethical accounting

Background:

Unethical accounting and auditing practices have directly led to the meltdown of several gigantic corporations in the last few years alone. Since Congress has addressed many of these issues for publicly held companies through the Sarbanes-Oxley Act of 2002, this exercise focus on accounting ethics of smaller, privately held firms.

Relationship to Text:

Learning Objective 3 – GAAP and FASB

Estimated Class Time:

About 10 minutes

Preparation/Materials:

None needed

Exercise:

Share with your students this slightly modified quotation from comedian Evan Esar: *Definition of Accounting: The science of producing unreliable facts from reliable figures*. Ask your class what it could mean. Help them understand the accountant’s role in interpreting—and possibly misrepresenting—the data that he or she reports.

Explain to your students that the Sarbanes-Oxley Act minimizes the possibilities of financial misrepresentation at publicly held companies, but there are no such controls for smaller, privately held companies.

Divide your class into groups of 3 to 5 students, and challenge each group to develop a plan for ensuring that small companies engage in ethical accounting practices. What kinds of checks and balances make the most sense? At what point do they become overly time-consuming or counterproductive? How deeply should the government be involved? Why? Should the measures you suggest be voluntary or mandatory? Why?

After about 10 minutes, ask each group to report its plan to the class. Help them understand that the party most directly harmed by accounting misdeeds is typically the public (harmed via underpaid taxes), which is why the IRS is currently the only entity with significant oversight responsibility. Any additional measures would probably need to be voluntary.

# **3 - Financial Statements**

Learning Objective: 5

Purpose:

To underscore the importance of financial statements in understanding the value of corporations

Background:

Many students seem to view financial statements as an exercise in and of itself rather than as a valuable source of information about corporations. This exercise is designed to counter that perception by helping students discover the relationship between financial statements and investment decisions.

Relationship to Text:

Learning Objective 5 – Financial Statements

Estimated Class Time:

About 20 minutes

Preparation/Materials:

None needed

Exercise:

NOTE: This exercise is most effective after you have covered the information on financial statements. Divide your class into groups of 3 to 5 students. Announce that each group represents a team of investment advisors for a client with $100,000 to invest in the stock of publicly traded companies. Your client—who has just enough accounting knowledge to be dangerous—has asked you to justify your advice based on the financial statements of the companies you recommend.

Your challenge is to determine what specific information from each financial statement could help you make your choice (possibilities include earnings, cash reserves, stock repurchases, level of debt, dividend payments, etc.). What does that information tell you about the investment potential of the company? Which of the three key statements—the balance statement, the income statement, and the statement of cash flows—is most important? Why? (Answers will vary based on investment philosophy.) Give the groups 10–15 minutes to develop a response.

Reconvene as a class to compare and contrast results. You will probably find that responses are interesting and thoughtful, but all over the place. You could use the range of ideas to emphasize the importance of investment objectives in determining a strategy for financial research.

# **4 - Income Statements**

Learning Objective: 5

Purpose:

To help students more clearly understand the relationship between revenue and profits

Background:

Many students seem to assume that the sure path to profits—especially in a retail or e-commerce environment—is simply to charge a “huge” markup. This exercise is designed to provide a high-impact, realistic demonstration of the costs incurred to generate revenue.

Relationship to Text:

Learning Objective 5 – The Income Statement

Estimated Class Time:

About 15 minutes

Preparation/Materials:

You’ll need to gather $100 cash, using twenties, tens, fives, and ones. Don’t worry . . . all but $2 will be returned to you. If this won’t work for either you or your class, you could also use play money (try raiding a Monopoly game), but it tends to be less effective. You’ll also need to make mock-up invoices using large print on index cards:

* Cost of merchandise $50
* Markdowns on other goods $10
* Advertising $3
* Rent $10
* Salaries and wages $15
* Insurance and local taxes $2
* Utilities $2
* Travel to market $2
* Supplies (hangers, sacks, etc.) $1
* Shrinkage $2

Exercise:\*

Request two volunteers who are interested in the retail business to sell you an item for $100, with the understanding that they can split the profits. Ask for a third volunteer to be the controller. Invite the three to the front of the room, and buy from them an apparel item (e.g., a jacket or shoes) for $100 cash. When you hand the $100 to one of the “partners,” hand a stack of invoices (see above) to the “controller,” payable today. Instruct the controller to present the invoices to the partners, who must then pay you.

Each invoice provides an opportunity to discuss a cost issue and possible strategic alternatives. For instance, Cost of Merchandise indicates only a 50 percent initial markup; perhaps the partners should have tried for a higher markup. Markdowns on other goods and advertising demonstrate the “cost” of having a sale, and also perhaps the reason for their current customer’s store visit. Rent, salaries and wages, insurance and local taxes, utilities, and supplies represent key, unavoidable costs of a retail business. Travel to market and shrinkage demonstrate the need for control in the retail organization.

At the end, do not forget to collect $1 in Federal Income Taxes from the “partners”! They should be left with $1 each in profits, plus a much better understanding of the relationship between revenue and profit.

\*Source: Pulling, Chris, “Retail Profits: No Room for Error, Great Ideas for Teaching Marketing,” downloaded 8/23/03 from

<http://www.swlearning.com/marketing/gitm/gitm4e02-08html>.

# **5 - Budgeting**

Learning Objective: 7

Purpose:

To highlight the importance of personal budgeting

Background:

Sadly, many students do not follow personal budgets, and a staggering number are already struggling with unmanageable credit card debt. This exercise is designed not only to emphasize the importance of personal budgeting, but also to encourage students to begin tracking and managing their expenses.

Relationship to Text:

Learning Objective 7 – Budgeting

Estimated Class Time:

About 10 minutes

Preparation/Materials:

None needed

Exercise:

Ask your class for a show of hands from those who agree with each of the following statements:

* I spend pretty much all of my money as soon as I get it.
* I sometimes take cash advances on my credit card.
* I always know how much money I have.
* I lend money to friends who ask, even when it leaves me short of cash.
* I know about how much I spend each week on “extra” expenses (movies, sodas, etc.).
* I always shop for the best value on significant purchases.
* I am not setting aside any savings while I am in college.

Clearly these statements represent a mix of positive and negative budgeting habits. As your students respond—and as they watch their classmates respond—you can draw their attention to the upsides and downsides of each approach. Help them weigh the benefits of each budgeting habit versus the opportunity costs. For example, shopping for the best value on a new computer might take 4–6 valuable hours, but might save $100 or more. Using those 4–6 hours to work at a $10/hour job, a student could only earn $40–$60 (less taxes!). Plainly, the shopping time is worthwhile.

Finally, brainstorm with your students some tips and techniques for personal budgeting. For example, recording every expense for a month is a great way to get a handle on spending (and to control excessive spending!).