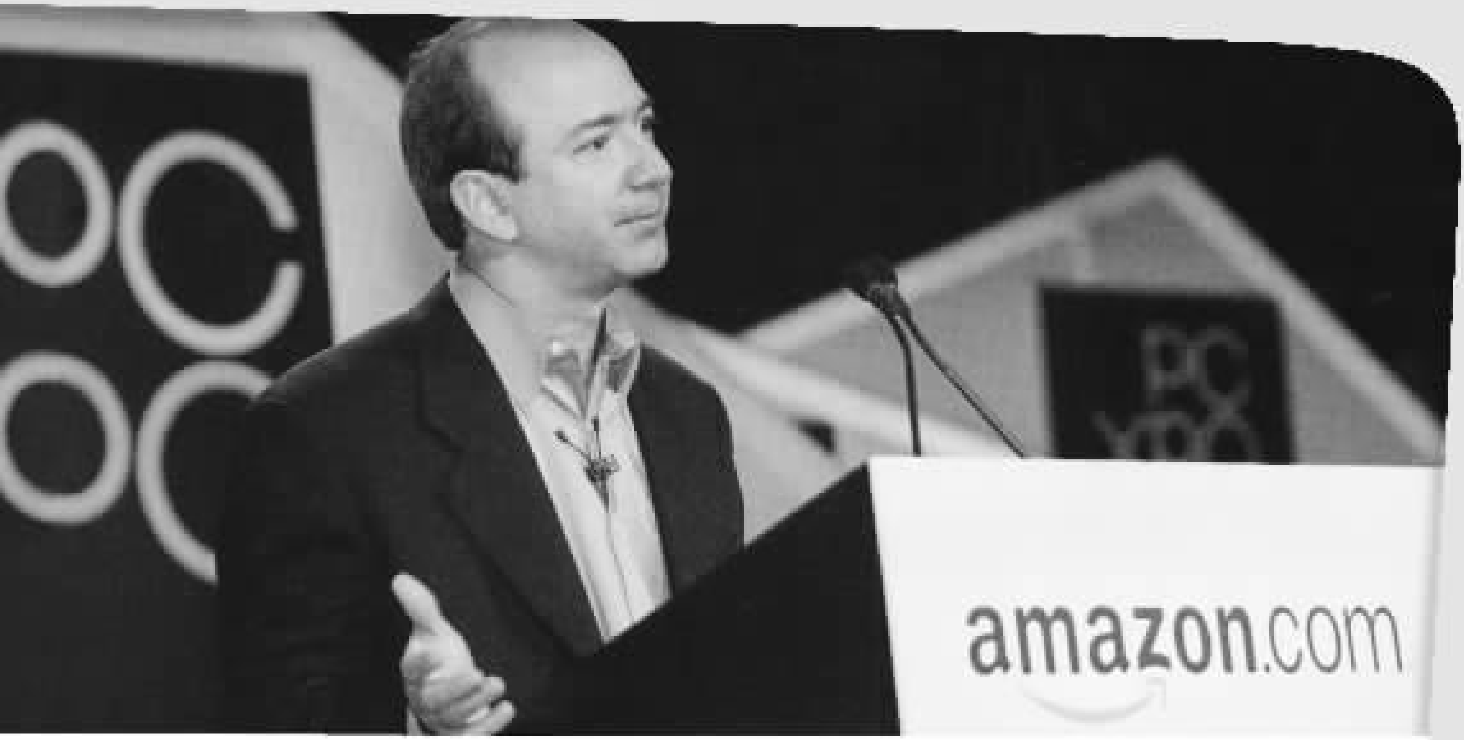
CHAPTER 1

Accounting and the Business Environment

A+ TIPS CHECK YOUR RESOURCES

- Visit the www.prenhall.com/horngren **Web site** for self-study quizzes, video clips, and other resources
- Try the **Quick Check** exercise at the end of the chapter to test your knowledge
- Learn the **key terms**
- Do the **Starter** exercises keyed in the margins
- Work the **end-of-chapter summary problems**
- Use the **Concept Links** to review material in other chapters



LEARNING OBJECTIVES

1. Use accounting vocabulary
2. Apply accounting concepts and principles
3. Use the accounting equation
4. Analyze business transactions
5. Prepare the financial statements
6. Evaluate business performance

Like most other people, you've probably bought **Amazon.com** products by shopping online. And like most other people, you've probably been amazed at how easy it is. Amazon.com is one of the most interesting organizations on earth. Consider these facts about the company:

- Amazon.com opened its virtual doors in 1995.
- In only a few years, millions of people in 220 countries have made it the world's leading online shopping site.
- It offers the world's largest selection of products.
- On Amazon.com's busiest shopping day of 2002, customers ordered 1.7 million units. That's 20 items per second, around the clock.
- There is still no Amazon.com store anywhere except online.

Amazon.com

Amazon.com continues to add partners and merchandise at breakneck speed. But it took from 1995 to 2002 for the company to post a profit. And it reported the figures using standard accounting methods.

What does all this mean? What does "profitable" mean? What are standard accounting methods? How can a company keep growing if it isn't making money? Lots of questions! And here's where accounting comes in. "Profitable" means that the company earns more revenue than its expenses. Accounting methods govern how companies keep track of their activities. This book will help you understand revenues, expenses, profit and loss, and other business concepts. After completing this first accounting course, you will be able to decide whether a company is a good (or bad) investment. You will be able to evaluate an auto loan and manage your own money. You will also be able to use accounting in your business career. ■

Sitemap

- The Language of Business
- Regulating Accounting
- Business Organizations
- Concepts and Principles
- The Accounting Equation
- Business Transactions
- Evaluating Transactions

We'll start our study with a small, single-person business known as a proprietorship. We need to begin by asking exactly what accounting is.

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Accounting: The Language of Business

Accounting is the information system that measures business activity, processes the information into reports, and communicates the results to decision makers. Accounting is "the language of business." The better you understand the language, the better your decisions will be, and the better you can manage your finances. For example, how will you decide whether to borrow money? You had better consider your income. The concept of income comes straight from accounting.

A key product of accounting is a set of documents called financial statements. **Financial statements** report on a business in monetary terms. Is Amazon.com making a profit? Should Amazon expand? Answering these questions calls for Amazon's financial statements.

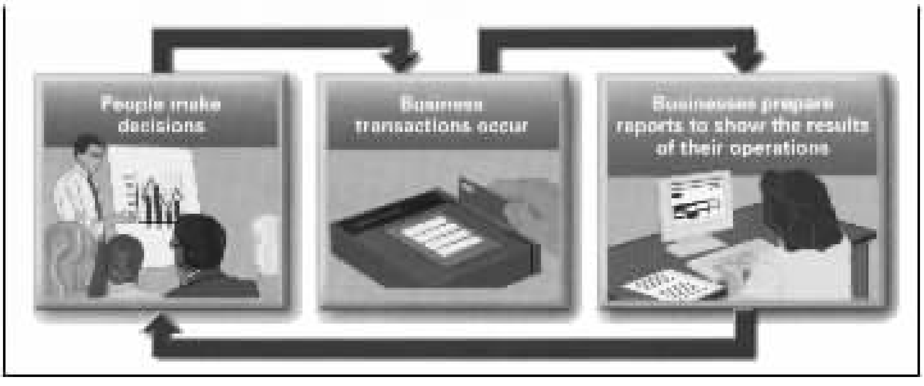
Exhibit 1-1 illustrates the role of accounting in business. The process starts and ends with people making decisions.

★ Use accounting vocabulary

Accounting
The information system that measures business activities, processes that information into reports, and communicates the results to decision makers.

Financial Statements
Documents that report on a business in monetary amounts, providing information to help people make informed business decisions.

Exhibit 1-1 The Accounting System: The Flow of Information



Decision Makers: The Users of Accounting Information

Decision makers need information. The bigger the decision, the greater the need. Here are some decision makers who use accounting information.

Individuals You use accounting information to manage your bank account, evaluate a new job prospect, and decide whether to rent or buy a house. Amazon.com employees in Seattle, Washington, make the same decisions that you do.

Businesses Managers use accounting information to set goals for their organizations. They also evaluate progress toward those goals, and they take corrective action when it's needed. For example, Amazon must decide which software to purchase, how many DVDs and books to keep on hand, and how much money to borrow. Accounting provides the information for making these decisions.

Investors Investors provide the money to get a business going. To decide whether to invest, a person predicts the amount of income on the investment. This means analyzing the financial statements and keeping up with company developments—using, for example, www.yahoo.com (click on Finance), www.hoovers.com (click on Companies), the SEC's EDGAR database, and *The Wall Street Journal*.

Creditors Before lending money, a bank evaluates the borrower's ability to make the payments. This evaluation includes a report on the borrower's financial position and predicted income. To borrow money before striking it rich, Jeff Bezos, the president of Amazon.com, probably had to document his income and financial position.

Government Regulatory Agencies Most organizations face government regulation. For example, the Securities and Exchange Commission (SEC), a federal agency, requires businesses to report their financial information to the public.

Taxing Authorities Local, state, and federal governments levy taxes. Income tax is figured using accounting information. Sales tax depends upon a company's sales.

Nonprofit Organizations Nonprofit organizations—churches, hospitals, and colleges—use accounting information the same way as Amazon.com and The Coca-Cola Company.

Financial Accounting and Management Accounting

Accounting can be divided into two fields—financial accounting and management accounting.

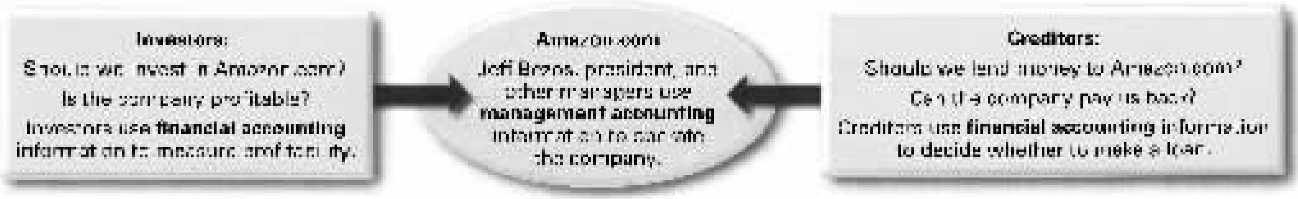
Financial accounting provides information for people outside the company. Lenders and outside investors are not part of day-to-day management. These people use the company's financial statements. Chapters 2–18 of this book deal primarily with financial accounting.

Financial Accounting
The branch of accounting that focuses on information for people outside the firm.

Management accounting focuses on information for internal decision makers, such as the company's executives and the administrators of a hospital. Exhibit 1-2 illustrates the difference between financial accounting and management accounting.

Management Accounting
The branch of accounting that focuses on information for internal decision makers of a business.

Exhibit 1-2 Financial Accounting and Management Accounting



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Regulating Accounting

All professions have regulations. Let's see the organizations that most influence the accounting profession.

Governing Organizations

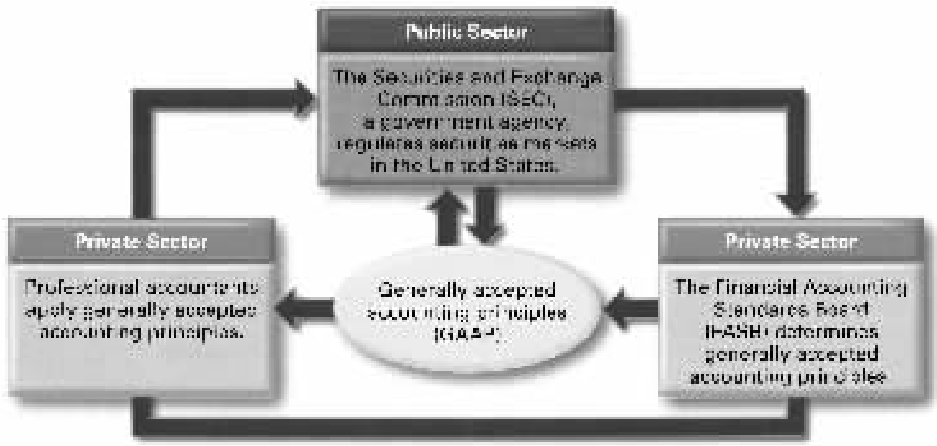
In the United States, a private organization called the **Financial Accounting Standards Board (FASB)** formulates accounting standards. The FASB works with a governmental agency, the SEC, and two private groups, the American Institute of Certified Public Accountants (AICPA) and the Institute of Management Accountants (IMA). **Certified public accountants**, or **CPAs**, are professional accountants who are licensed to serve the general public. **Certified management accountants**, or **CMAs**, are professional accountants who work for a single company. Both groups of accountants have passed qualifying exams.

Financial Accounting Standards Board (FASB)
The private organization that determines how accounting is practiced in the United States.

Certified Public Accountant (CPA)
A licensed accountant who serves the general public rather than one particular company.

The rules that govern public accounting information are called *generally accepted accounting principles (GAAP).* Exhibit 1-3 diagrams the relationships among the various accounting organizations.

Exhibit 1-3
Key Accounting Organizations



Ethics in Accounting and Business

Certified Management Accountant (CMA)
A licensed accountant who works for a single company.

Audit
An examination of a company's financial situation.

Ethical considerations affect everything accountants do. Investors and creditors need relevant and reliable information about a company such as **Amazon.com** or **General Motors**. The companies naturally want to make themselves look as good as possible in order to attract investors. There is potential for conflict here. To provide reliable information for the public, the SEC requires companies to have their financial statements audited by independent accountants. An **audit** is a financial examination. The accountants then certify that the financial statements give a true picture of the company's situation.

The vast majority of accountants do their jobs quietly, professionally, and ethically. We never hear about them. Unfortunately, only those who bend the rules make the headlines. In recent years we've seen more accounting scandals than at any time since the 1920s.

Enron Corp., for example, was the seventh-largest company in the United States before the company admitted reporting fewer debts than it really owed. **WorldCom**, a major long-distance telephone provider, admitted accounting for expenses as though they were assets (resources). **Xerox Corp.** was accused of manipulating reported profits. These and other scandals rocked the business community and hurt investor confidence. Innocent people lost their jobs, and the stock market suffered. The courts are still sorting out who was responsible for the flawed information and its consequences.

The New Economy: Pumping Up Revenue via Round-Trip Trades

The stock market can get obsessed with revenue, and that can put intense pressure on companies to boost their revenue figures. "Round-trip trades" are one technique for reporting high revenues. These deals typically involve a swap of assets or services without any real gains. Two companies get together and set a price for advertising on each other's Web sites at, say, $1 million. They then swap banners and each declares $1 million as revenue and $1 million for expenses—but not a single penny changes hands. Here are some examples:

- In 1999, the women's Web site **iVillage** revealed that 20% of its revenue came from round-trip trades of online advertising.
- In 2001, **CMS Energy** and **Dynegy** completed two electricity trades worth $1.7 billion on Dynegy's online trading platform. The trades cancelled each other out, but the companies cited the artificially boosted revenues in their press releases.
- With revenues lagging, telecom companies **Global Crossing** and **Qwest** began booking revenue from capacity swaps in 1999.

The SEC began investigating round-trip trades when it learned that many of the transactions served only to inflate revenue, and in 2002 it barred telecom trades that inflate revenue. Earlier, in 1999, the FASB forced companies to disclose online advertising swaps as "barter revenue." Yet, scrutiny from shareholders and accounting regulatory agencies hasn't stopped everyone.

Homestore, Inc., an online real estate company, and **America Online** are now under investigation for complex multiparty deals in which Homestore allegedly bought products from a third company, which then bought ads on America Online. The days of round-trip trades may be over.

Based on Dennis K. Berman, Julia Angwin, and Chip Cummins, "What's Wrong?—Tricks of the Trade: As Market Bubble Neared End, Bogus Swaps Provided a Lift," *The Wall Street Journal*, December 23, 2002, p. A1. David Wessel, "What's Wrong?—Venal Sins: Why the Bad Guys of the Boardroom Emerged en Masse," *The Wall Street Journal*, June 20, 2002, p. A1. Susan Pulliam and Rebecca Blumenstein, "SEC Broadens Investigation into Revenue-Boosting Tricks," *The Wall Street Journal*, May 16, 2002, p. A1.

Standards of Professional Conduct

The AICPA's Code of Professional Conduct for Accountants provides guidance to CPAs in their work. Ethical standards are designed to produce relevant and reliable information for decision making. The preamble to the Code states: "[A] certified public accountant assumes an obligation of self-discipline above and beyond the requirements of laws and regulations . . . [and] an unswerving commitment to honorable behavior. . . ."

The opening paragraph of the Standards of Ethical Conduct of the Institute of Management Accountants (IMA) states: "Management accountants have an obligation to the organizations they serve, their profession, the public, and themselves to maintain the highest standards of ethical conduct." The requirements are similar to those in the AICPA code.

Most corporations also set standards of ethical conduct for employees. For example, **The Boeing Company**, a leading manufacturer of aircraft, has a highly developed set of business conduct guidelines. The chairperson of the board states: "We owe our success as much to our reputation for integrity as we do to the quality and dependability of our products and services. This reputation is fragile and can easily be lost." As one chief executive has stated, "Ethical practice is simply good business."

Truth is always better than dishonesty—in accounting, in business, and in life.

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Types of Business Organizations

A business can have one of three forms of organization: proprietorship, partnership, or corporation. You should understand the differences among the three.

Proprietorship
A business with a single owner.

PROPRIETORSHIPS A **proprietorship** has a single owner, called the proprietor, who is often the manager. Proprietorships tend to be small retail stores or professional businesses, such as physicians, attorneys, and accountants. From the accounting viewpoint, each proprietorship is distinct from its proprietor: The accounting records of the proprietorship do *not* include the proprietor's personal financial records. However, from a legal perspective, the business *is* the proprietor. In this book, we begin the accounting process with a proprietorship.

Partnership
A business with two or more owners.

PARTNERSHIPS A **partnership** joins two or more individuals as co-owners. Each owner is a partner. Many retail establishments and professional organizations of physicians, attorneys, and accountants are partnerships. Most partnerships are small or medium-sized, but some are gigantic, exceeding 2,000 partners. Accounting treats the partnership as a separate organization, distinct from the personal affairs of each partner. But again, from a legal perspective, a partnership *is* the partners.

Corporation
A business owned by stockholders; it begins when the state approves its articles of incorporation. A corporation is a legal entity, an "artificial person," in the eyes of the law.

Stockholder
A person who owns stock in a corporation. Also called a **shareholder**.

CORPORATIONS A **corporation** is a business owned by **stockholders**, or **shareholders**. These are the people who own shares of ownership in the business. A business becomes a corporation when the state approves its articles of incorporation. A corporation is a legal entity that conducts business in its own name. Unlike the proprietorship and the partnership, the corporation is not defined by its owners.

Corporations differ significantly from proprietorships and partnerships in another way. If a proprietorship or a partnership cannot pay its debts, lenders can take the owners' personal assets—their cash—to satisfy the business's obligations. But if a corporation goes bankrupt, lenders cannot take the personal assets of the stockholders. This *limited liability* of stockholders for corporate debts explains why corporations are so popular: People can invest in corporations with limited personal risk.

Another factor in corporate growth is the division of ownership into individual shares. The **Coca-Cola Company**, for example, has billions of shares of stock owned by many stockholders. An investor with no personal relationship to Coca-Cola can become a stockholder by buying 50, 100, 5,000, or any number of shares of its stock.

Exhibit 1-4 summarizes the differences among the three types of business organization.

Exhibit 1-4 Comparison of the Three Forms of Business Organization

	Proprietorship	Partnership	Corporation
1. Owner(s)	Proprietor—there is only one owner	Partners—there are two or more owners	Stockholders—there are generally many owners
2. Life of the organization	Limited by the owner's choice, or death	Limited by the owners' choices, or death	Indefinite
3. Personal liability of the owner(s) for the business's debts	Proprietor is personally liable	Partners are personally liable	Stockholders are not personally liable
4. Legal status of the organization	The proprietorship is the proprietor	The partnership is the partners	The corporation is separate from the stockholders

Accounting Concepts and Principles

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The rules that govern accounting fall under the heading **GAAP**, which stands for **generally accepted accounting principles**. GAAP is the "law" of accounting—rules for providing the information that is acceptable to the majority of Americans.

GAAP rests on a conceptual framework written by the FASB: *The primary objective of financial reporting is to provide information useful for making investment and lending decisions*. To be useful, information must be relevant, reliable, and comparable. We begin the discussion of GAAP by introducing basic accounting concepts and principles.

2 Apply accounting concepts and principles

Generally Accepted Accounting Principles (GAAP)
Accounting guidelines, formulated by the Financial Accounting Standards Board, that govern how accountants measure, process, and communicate financial information.

Entity
An organization or a section of an organization that, for accounting purposes, stands apart from other organizations and individuals as a separate economic unit.

The Entity Concept

The most basic concept in accounting is that of the **entity**. An accounting entity is an organization or a section of an organization that stands apart as a separate economic unit. In accounting, boundaries are drawn around each entity so as not to confuse its affairs with those of other entities.

Consider **Amazon.com**. Assume Jeff Bezos started Amazon.com on his own. Suppose he began with $5,000 obtained from a bank loan. Following the entity concept, Bezos would account for the $5,000 separately from his personal assets, such as his clothing, house, and automobile. To mix the $5,000 of business cash with his personal assets would make it difficult to measure the financial position of Amazon.com.

Consider **Toyota**, a huge organization with several divisions. Toyota management evaluates each division as a separate accounting entity. If sales in the Lexus division are dropping, Toyota can find out why. But if sales figures from all divisions of the company are combined, management will not know that Lexus sales are going down. Thus, the entity concept applies *to any economic unit that needs to be evaluated separately*.

The Reliability (Objectivity) Principle

Accounting information is based on the most reliable data available. This guideline is the *reliability principle*, also called the *objectivity principle*. Reliable data are verifiable. They may be confirmed by any independent observer. For example, an Amazon.com bank loan is supported by a promissory note. This is objective evidence of the loan. Without the reliability principle, accounting data might be based on whims and opinions.

Suppose you want to open an electronics store. For a store location, you transfer a small building to the business. You believe the building is worth $150,000. To confirm its cost to the business, you hire two real estate appraisers, who value the building at $140,000. Which is the more reliable estimate of the building's value, your estimate of $150,000 or the $140,000 professional appraisal? The appraisal of $140,000 is more reliable because it is supported by an independent observation. The business should record the building cost as $140,000.

The Cost Principle

The *cost principle* states that acquired assets and services should be recorded at their actual cost (also called *historical cost*). Even though the purchaser may believe the price is a bargain, the item is recorded at the price actually paid and not at the "expected" cost. Suppose your electronics store purchases TV equipment from a supplier who is going out of business. Assume that you get a good deal and pay only $2,000 for equipment that would have cost you $3,000 elsewhere. The cost principle requires you to record the equipment at its actual cost of $2,000, not the $3,000 that you believe the equipment is worth.

The cost principle also holds that the accounting records should maintain the historical cost of an asset over its useful life. Why? Because cost is a reliable measure. Suppose your store holds the TV equipment for six months. During that time TV prices rise, and the equipment can be sold for $3,500. Should its accounting value—the figure "on the books"—be the actual cost of $2,000 or the current market value of $3,500? By the cost principle, the accounting value of the equipment remains at actual cost: $2,000.

Stop & Think

You are considering the purchase of land for future expansion. The seller is asking $50,000 for land that cost her $35,000. An appraisal shows a value of $47,000. You first offer $44,000. The seller counteroffers with $48,000, and you agree on a price of $46,000. What dollar value for this land is reported on your financial statements? Which accounting concept or principle guides your answer?

Answer: According to the cost principle, assets and services should be recorded at their actual cost. You paid $46,000 for the land, so report the land at $46,000.

The Going-Concern Concept

Another reason for measuring assets at historical cost is the *going-concern concept*. This concept assumes that the entity will remain in operation for the foreseeable future. Under the going-concern concept, accountants assume that the business will remain in operation long enough to use existing resources for their intended purpose.

To understand the going-concern concept better, consider the alternative—which is to go out of business. A store holding a going-out-of-business sale is trying to sell everything. In that case, instead of historical cost, the relevant measure is current market value. But going out of business is the exception rather than the rule.

The Stable-Monetary-Unit Concept

In the United States, we record transactions in dollars because the dollar is the medium of exchange. British accountants record transactions in pounds sterling. French and German transactions are measured in euros. The Japanese record transactions in yen. The value of a dollar or a Mexican peso changes over time. A rise in the price level is called *inflation*. During inflation, a dollar will purchase less milk, less gas for your car, and less of other goods. When prices are stable—when there is little inflation—the purchasing power of money is also stable.

Accountants assume that the dollar's purchasing power is stable. It allows us to add and subtract dollar amounts as though each dollar has the same purchasing power as any other dollar at any other time.

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The Accounting Equation

The basic tool of accounting is the **accounting equation**. It measures the resources of a business and the claims to those resources.

3 Use the accounting equation

Accounting Equation
The basic tool of accounting, measuring the resources of the business and the claims to those resources: Assets = Liabilities + Owner's Equity.

Asset
An economic resource that is expected to be of benefit in the future.

Assets and Liabilities

Assets are economic resources that are expected to be of benefit in the future. Cash, merchandise inventory, furniture, and land are assets.

Claims to those assets come from two sources. **Liabilities** are *outsider* claims—debts that are payable to outsiders. These outside parties are called *creditors*. For example, a creditor who has loaned money to **Amazon.com** has a claim to some of Amazon's assets until Amazon pays the debt.