Chapter 2

What Should Decision Makers Know in Order to Make Good Decisions about an Organization?

Video Clip

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In this video, Professor Joe Hoyle introduces the essential points covered in Chapter 2 "What Should Decision Makers Know in Order to Make Good Decisions about an Organization?".

2.1 Creating a Portrait of an Organization That Can Be Used by Decision Makers

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Explain the comparison of financial accounting to the painting of a portrait.
2. Understand the reasons why financial accounting information does not need to be exact.
3. Define the term "material" and describe its fundamental role in financial accounting.
4. Define the term "misstatement" and differentiate between the two types of misstatements: errors and fraud.

Financial Statements: The Portrait of an Organization

Question: In Chapter 1 "What Is Financial Accounting, and Why Is It Important?", mention was made that financial accounting is somewhat analogous to the painting of a giant, complex portrait. How could financial accounting possibly be compared to an artistic endeavor such as the creation of a painted portrait?

Answer: The purpose of a portrait—as might have been created by Rembrandt, van Gogh, or even Picasso—is to capture a likeness of the artist's model. In a somewhat parallel fashion, financial accounting attempts to present a portrait of an organization that can be used by interested parties to assess its financial health and future prospects. If well painted, this picture should enable individuals to estimate future stock prices, dividend payments, and cash flows. Accounting even has specific terms (such as **representational faithfulness**[1] and **presents fairly**[2]) that are used to indicate that financial information successfully provides a reasonable likeness of the reporting organization.

In accounting, this portrait is most often presented in the form of **financial statements**[3]. The accountant takes all appropriate monetary information and

1. A reasonable agreement between reported information and the event or balance it purports to represent; this term refers to the communication of an appropriate picture of an organization, which can serve as the basis for appropriate decisions.

2. Financial information that contains no material misstatements in accordance with an accepted standard for financial reporting.

3. Quantitative reports and related verbal disclosures that convey monetary information describing the operations, financial position, and cash flows of an organization as a basis for representing its financial health and future prospects.

constructs a set of financial statements to be distributed to decision makers. Financial statements are a representation of an organization's operations, financial position, and cash flows. These statements provide the form and structure for the conveyance of financial information that will create a likeness of the reporting organization. This textbook is about the preparation of those financial statements and the meaning of their contents.

A Likeness Does Not Have to Be Exact

Question: Financial accounting deals with numbers that are exact. A 3 is a 3 and nothing else. In describing the production of financial statements, why are the results not compared to a photograph rather than a painted portrait? After all, a photograph is a much more precise likeness than a painting.

Answer: A human portrait, even by a master such as Rembrandt, will not be completely accurate. The shape of the person's chin or the turn of the neck may be off slightly. The color of the eyes and hair cannot possibly be a perfect replica of life. It is a painted portrait, not a photograph (which is much more mechanically accurate). Fortunately, absolute exactness is not necessary for capturing the essence of a model. A likeness is achieved when a viewer exclaims, "I know that person!" Exact precision is not required to meet that objective.

Despite public perception to the contrary, financial accounting information is rarely an exactly accurate portrait. The accountant's goal is to create financial statements that present a likeness of an organization that can be used to make decisions. For example, the reported cost of constructing a building may be off slightly because of the sheer volume of money being spent on the many different aspects of the project. No one expects the reported cost of a $50 million manufacturing plant to be accurate to the penny. As with the painted portrait, that does not necessarily reduce the usefulness of the data. If financial information provides a fair representation, an interested party should be able to make use of it to arrive at the desired projections such as future stock prices. A potential investor or creditor does not need numbers that are absolutely accurate in order to assert, "Based on the information available in the financial statements, I understand enough about this business to make informed decisions. Even if I could obtain figures that were more accurate, I believe that I would still take the same actions."

An artist applies oil paints, pastels, or watercolors to a canvas to present a likeness of a subject. An accountant does something quite similar in constructing financial statements with numbers and words. The goal is much the same: to produce a likeness that truly reflects the essence of the model, which, in this case, is an entire organization.

TEST YOURSELF

Question:

For the year ending January 31, 2011, **Walmart** reported having made sales to its customers (net of returns and allowances) of $418,952,000,000. James Forrest is studying the available information in order to decide whether to buy ownership shares of **Walmart** on the New York Stock Exchange at the current price. Which of the following statements is true about the figure reported as the company's net sales?

a. **Walmart** made net sales during these twelve months of exactly $418,952,000,000.
b. The $418,952,000,000 is accurate, although the number has been rounded to the nearest million.
c. Net sales were probably not $418,952,000,000 for the year, but that figure is close enough to be a fair presentation, one that Forrest can rely on in making his decision.
d. If this net sales figure had not been correct, **Walmart's** accountants would not have allowed the company to report the amount.

Answer:

The correct answer is choice c: Net sales were probably not $418,952,000,000 for the year, but that figure is close enough to be a fair presentation, one that Forrest can rely on in making his decision.

Explanation:

Accounting data are rarely accurate. That degree of exactness is often impossible to achieve and is not required when assessing a company's financial health. Financial statements are created to provide a fair presentation. Forrest ultimately wants to estimate stock prices and dividend payments. Net sales were almost certainly not as reported, but any difference between this number and the actual amount is not expected to be large enough to have an impact on the decisions that will be made.

Material Misstatements

Question: This is a surprising, possibly shocking, revelation. Financial accounting information has universally been branded as exhibiting rigid exactness. In fact, accountants are often referred to as "bean counters" because of their perceived need to count every bean in the bowl to arrive at obsessively accurate numbers. Here, though, the assertion is made that accounting information is not a precise picture but merely a fair representation of an organization's financial health and future prospects. How correct or exact is the financial information that is reported by a business or other organization?

Answer: In financial accounting, the data presented to decision makers by an organization should never contain any **misstatements**[4] that are deemed to be **material**[5]. This basic standard has long served as the required level for accuracy in financial reporting. Decision makers want financial statements—such as those prepared by **Starbucks** or **Intel**—that they can trust and use. That requires the statements to be free of any material misstatements. In that condition, reported financial information will be viewed as a likeness of the organization that is presented fairly. Thus, financial statements do not need exact accuracy. However, they must be free of material misstatements in order to be of use to decision makers.

A misstatement is an **error**[6] (made accidentally) or **fraud**[7] (done intentionally) where reported figures or words actually differ from the underlying reality. In simple terms, the information is wrong.

For example, a corporate official could erroneously record a $100,000 expenditure that was made in connection with the construction of a new building as if it pertained to the purchase of land. Consequently, the building's cost might be reported as only $2.3 million when it was actually $2.4 million. This reported number is misstated; it is wrong. The balance presented for the building contains a $100,000 error, as does the figure shown for land. This misstatement, though, might not be viewed as material.

A misstatement is deemed to be material if it is so significant that its presence would impact a decision made by an interested party. Using the previous illustration, assume the accidental $100,000 reduction in the reported cost of this building leads an outside decision maker to alter a choice being made (such as whether to buy or sell the business's capital stock or whether to grant a loan). Because of the change in the decision, the misstatement is judged to be material by definition. If no decision is affected, a misstatement is not material, and its

4. Errors or frauds that cause reported financial information to differ from the approach required by an official standard for reporting such as the U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS).
5. The magnitude of an omission or misstatement of accounting information that makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by that omission or misstatement.
6. An unintentional misstatement of financial information.
7. An intentional misstatement of financial information; it can result from misappropriation of assets (theft) or fraudulent financial reporting.

existence does not prevent the reported information from still being fairly presented. The reported information is usable for decision making.

Financial information can (and almost always does) contain misstatements. However, the reporting entity must take adequate precautions to ensure that reported information holds no material misstatements for the simple reason that it is no longer fairly presented. If any material misstatements exist within the information, the portrait of the organization is not a proper likeness of the model. The decision maker is being misled.

The concept of materiality can seem rather nebulous. For the financial statements of a small convenience store, a $10 misstatement is not material whereas a $10 million one certainly is. For a business with real estate holdings of $30 billion, even a $10 million misstatement is probably not material. The problem for the accountant is determining where to draw the line for a particular organization. That is one of the most difficult decisions for any financial accountant. An exact dollar amount for materiality is virtually impossible to identify because it is a measure of the effect of a misstatement on an external party's judgment.

Other than sheer magnitude, the cause of the problem must also be taken into consideration. An accidental mistake of $100,000 is less likely to be judged material than one of $100,000 that resulted from a fraudulent act. Fraud occurs when someone wants to misrepresent reported numbers to make the organization look differently than it is or to cover theft. Fraud includes the intent to deceive and is more troublesome to decision makers than a mere error. Thus, both size and cause should be weighed in considering whether the presence of a misstatement has the ability to impact the actions of any decision makers.

Consequently, a financial accountant never claims that reported information is correct, accurate, or exact. Such precision is rarely possible and not needed when decision makers are analyzing the financial health and future prospects of an organization. However, the accountant must take all precautions necessary to ensure that reported data contain no material misstatements. Financial figures are never released without reasonable assurance being obtained that no errors or other mistakes are included that could be material, or in other words, that could impact the decisions that are made. All parties need to believe that reported information can be used with confidence because it presents a fair likeness of the organization as a whole.

When a company reports that a building was constructed at a cost of $2.3 million, the real message is that the actual cost was not materially different from $2.3 million. This figure is a fair representation of the amount spent, one that can be used in making decisions about the organization such as whether to invest in its capital stock or provide it with a loan.

TEST YOURSELF

Question:

For the year ending January 31, 2011, **Walmart** reported earning net income of $16,389,000,000. Which of the following statements is not true?

a. Net income is probably not $16,389,000,000, but it is not materially different than the reported figure.
b. To aid investors, actual net income could be lower than $16,389,000,000 but should not be any higher.
c. Decision makers should feel comfortable making decisions about the company based on this figure.
d. With companies of such size, determining an exact net income is impossible.

Answer:

The correct answer is choice b: To aid investors, actual net income could be lower than $16,389,000,000 but should not be any higher.

Explanation:

Net income reflects a likeness of a company's earnings that a decision maker can use. With so many complex transactions, precisely accurate figures are impossible. Company officials do need to have sufficient evidence to indicate that net income contains no material misstatements. Accountants tend to be conservative, which is likely to reduce reported income figures. Therefore, actual net income is more likely to be slightly higher than the reported figure rather than lower.

KEY TAKEAWAY

Financial accounting does not attempt to provide exact numbers because such accuracy is often impossible to achieve and not really required by decision makers. Instead, reported accounting information is intended to provide a likeness of an organization and its operations—a type of portrait. To achieve this goal, financial accountants must ensure that reported balances and other data cannot contain any material misstatements. A misstatement is inaccurate information included by accident (an error) or intentionally (fraud). Materiality refers to the point at which the size or the nature of such misstatements would cause a change in the decisions made by an individual using that information. If all material misstatements can be eliminated, the information is considered to be presented fairly. That likeness can then be used by interested parties to make considered decisions.

2.2 Dealing with Uncertainty

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Discuss the challenge created for financial accountants by the presence of uncertainty.
2. List examples of uncertainty that an accountant might face in reporting financial information about an organization.
3. Explain how financial accounting resembles a language, such as Spanish or Japanese.

Uncertainty, the True Challenge for Reporting

Question: Financial accounting figures can certainly be exact. If a cash register is bought for $836.54, the reported cost is $836.54. However, decision makers do not need financial figures with such absolute accuracy. If reported information is presented fairly, in other words if it contains no material misstatements, it can be used to estimate a corporation's future stock prices, cash dividend payments, and cash flows. Even if not necessary for decision makers, what prevents reported financial information from being correct in an absolute sense? Why are all reported figures not as precise as the reporting of the cash register?

Answer: In truth, a reasonable percentage of numbers reported in a set of financial statements are exact. Materiality is not an issue in such cases. The cash register mentioned here has a reported cost of $836.54—a precise measure of the amount paid. Likewise, a cash balance shown as $2,785.16 is exact to the penny. However, many of the other figures reported by an organization do not lend themselves to such accuracy.

The primary reason that exactness is not a goal—often not even a possibility in financial accounting—can be summed up in a single word: uncertainty. Many of the events encountered every day by an organization contain some degree of uncertainty. Unfortunately, no technique exists to report uncertain events in precise terms.

When first introduced to financial accounting, many students assume that it is little more than the listing of cash receipts and disbursements in much the same way that elementary school children report how they spent their weekly allowances. That is a misconception. Financial accounting is a structured attempt to paint a fairly presented portrait of an organization's overall operations, financial condition, and cash flows. This requires the reporting of many events where a final resolution might not occur for months or even years. Here are just a few examples of the kinds of uncertainty that virtually every business (and financial accountant) faces in creating financial statements.

- A business is the subject of a lawsuit. Perhaps a customer has filed this legal action claiming damage as a result of one of the company's products. Such legal proceedings are exceedingly common and can drag on in the courts for an extended period of time before a settlement is reached. The actual amount won or lost (if either ever occurs) might not be known for years. What should the business report *now*?
- A sale of merchandise is made today for $300 with the money to be collected from the customer in several months. Until the cash is received, no one can be sure of the exact amount that will be collected. What should the business report *now*?
- An employee is promised a cash bonus next year that will be calculated based on any rise in the market price of the corporation's capital stock. Until the time passes and the actual increase (if any) is determined, the amount of this bonus remains a mystery. What should the business report *now*?
- A retail store sells a microwave oven today with a warranty. If the appliance breaks at any time during the next three years, the store has to pay for the repairs. No one knows whether the microwave will need to be fixed during this period. What should the business report *now*?

Any comprehensive list of the uncertainties faced regularly by most organizations would require pages to enumerate. Many of the most important accounting rules have been created to establish requirements for the reporting of uncertain situations. Because of the quantity and variety of such unknowns, exactness simply cannot be an objective of financial reporting.

For many accountants, dealing with so much uncertainty is the most interesting aspect of their job. Whenever an organization encounters a situation of this type, the accountant must first come to understand what has happened and then determine a logical method to communicate a fair representation of that information within the framework provided by financial accounting rules. Thus, reporting events in the face of uncertainty is surely one of the major challenges of being a financial accountant.

Accounting as the Language of Business

Question: Accounting is sometimes referred to as the "language of business." However, in this book, financial accounting has already been compared to the painting of a fairly presented portrait of an organization. Given the references throughout this chapter to painting, is accounting really a type of language? Is it possible for accounting to paint portraits and also be a language?

Answer: The simple answer to this question is that accounting is a language, one that enables an organization to communicate a portrait of its financial health and future prospects to interested parties by using words and numbers rather than oils or watercolors. The formal structure of that language becomes especially helpful when an organization faces the task of reporting complex uncertainties.

Any language, whether it is English, Spanish, Japanese, or the like, has been developed through much use to allow for the effective transfer of information between two or more parties. If a sentence such as "I drive a red car" is spoken, communication is successful but only if both the speaker and the listener have an adequate understanding of the English language. Based solely on the arrangement of these five words, information can be passed from one person to the another.

This process succeeds because English (as well as other languages) relies on relatively standardized terminology. Words such as "red," "car," and "drive" have defined meanings that the speaker and the listener both know with a degree of certainty. In addition, grammar rules such as syntax and punctuation are utilized to provide a framework for the communication. Thus, effective communication is possible in a language when

1. Set terminology exists
2. Structural rules and principles are applied

As will be gradually introduced throughout this textbook, financial accounting has its own terminology. Many words and terms (such as "LIFO" and "accumulated depreciation") have very specific meanings. In addition, a comprehensive set of rules and principles has been established over the decades to provide structure and standardization. They guide the reporting process so that the resulting information will be fairly presented and can be readily understood by all interested parties, both inside and outside of the organization.

Some students who read this textbook will eventually become accountants. Those individuals must learn specific terminology, rules, and principles in order to communicate financial information about an organization that is presented fairly. Others (probably most readers) will become external decision makers. They will make financial decisions. They will evaluate loan applications, buy capital stock, grant credit, make employment decisions, provide investment advice, and the like. They will not present financial information with all of its uncertainties but rather they will need to make use of it. The more such individuals know about financial accounting terminology, rules, and principles, the more likely it is that they will arrive at appropriate decisions.

To communicate a portrait properly in any language, both the speaker and the listener must understand the terminology as well as the structural rules and principles. That holds true even if the language is financial accounting.

KEY TAKEAWAY

At any point in time, organizations face numerous uncertain outcomes, such as the settlement of litigation or the collection of a receivable. The conveyance of useful information about these uncertain situations goes beyond the simple reporting of exact numbers. To communicate a fair representation of such uncertainty, financial accounting must serve as a language. Thus, it will have established terminology and structural rules much like that of any language. For successful communication of financial information, both the terminology and the structural rules must be understood by all parties involved.

2.3 The Need for Accounting Standards

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Describe the purpose of accounting standards such as U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS) and the benefits that these rules provide.
2. Explain the importance of accounting standards to the development of a capitalistic economy.
3. Understand the role played by the Financial Accounting Standards Board (FASB) in the ongoing evolution of accounting standards in the United States.
4. Discuss the advantages and the possibility that financial reporting will switch from U.S. GAAP to IFRS.

The Existence of Formal Accounting Standards

Question: Rules and principles exist within financial accounting that must be followed. They provide the structural guidance that is essential for achieving effective communication. For example, assume that a reporting organization encounters an uncertainty (such as a lawsuit) and is now preparing financial information to portray the reality of that event. When faced with such complexity, how does the financial accountant know which method of reporting is appropriate? How does a decision maker who analyzes that reported information know what guidelines were used in its preparation?

Answer: The existence of financial accounting standards is essential to ensure that all communicated information is understood properly. Both the accountants within the reporting organization and the decision makers analyzing the resulting financial statements must understand those rules. The question that has haunted the accounting profession in recent times is, who should have the authority to create those standards?

For decades, a wide variety of formal accounting principles were developed in the United States as well as throughout the rest of the world. Japanese accounting rules evolved differently from those in Australia while Australian standards were not consistent with those in the United States. In earlier times, such country-by-country rules caused few problems because most businesses operated solely within their country's boundaries. During the past ten years or so, as a truly global economy became a reality, two primary systems of accounting rules emerged. **U.S. Generally Accepted Accounting Principles (U.S. GAAP)**[8] are applied to most financial information presented within the United States. International Financial Reporting Standards (IFRS) are now used almost exclusively in the rest of the world. In accounting at the present time, two languages exist rather than one.

Having two bodies of rules causes problems for decision makers. For example, on its Web site, **BP** presents a 2010 set of financial statements prepared according to IFRS. One of its biggest competitors, **Exxon Mobil**, posted its own 2010 financial statements, but those amounts and explanations were created by following U.S. GAAP. Clarity and understanding are not enhanced when different communication standards are applied by such similar businesses.

Not surprisingly, many corporate officials and decision makers would prefer to see one universal set of accounting standards. If that were to happen, a corporation in Michigan and a corporation in Germany would produce comparable financial information that could be utilized for all reporting purposes around the world.

Over the past few years, extensive progress has been made in bringing these two sets of standards into alignment. However, a number of significant differences continue to exist. Many interested parties want to see IFRS adopted exclusively in the United States. According to this group, it is unlikely that the rest of the world will choose to follow U.S. GAAP so harmony can only be achieved by a general acceptance of IFRS. Others believe that U.S. GAAP is a superior system and should not be abandoned.

The debate has been intense and promises to continue to be so until some type of official resolution occurs.

8. A recognized set of accounting rules used and followed in the United States; it is created and updated by the Financial Accounting Standards Board (FASB).

Typical Opinions on Moving to the Use of IFRS

- "**Ford (Motor Co.)** supports the move to International Financial Reporting Standards, saying the company would save money by simplifying and standardizing its accounting across all 138 countries where **Ford** operates."
- "Companies like **Hallador Energy Co.**, a small Denver coal-mining company that doesn't do business outside the United States (opposes) moving to the international standards. 'We didn't join the metric system when everybody else did,' says W. Anderson Bishop, **Hallador's** chief financial officer. U. S. accounting rules are 'the gold standard, and why would we want to lower our standards just to make the rest of the world happy?"
- "Larger companies, big accounting firms, and top rule makers favor the switch. They contend that global unity would save companies money by consolidating bookkeeping and make it easier to raise capital around the world."
- "James Barlow, chief financial officer of drug company **Allergan Inc.** and an opponent of IFRS, estimates the change could cost companies as much as 1 percent of revenues."Michael Rapoport, "Accounting Move Pits Big vs. Small," *The Wall Street Journal*, July 6, 2011, C1.

At the time of this writing, U.S. GAAP continues to be the required system for most of the financial reporting found in the United States although a mandated switch to IFRS (in some form) during the next few years is quite possible. Because of the current situation and the uncertainty as to how legal requirements will eventually change, this textbook is primarily a presentation of U.S. GAAP. For the most part, U.S. GAAP and IFRS are based on the same accounting principles. However, varying interpretations of those principles have resulted in differences between U.S. GAAP and IFRS standards. In areas where IFRS disagrees with U.S. GAAP in significant ways, both methods of reporting will be described in this textbook.

The Development of Accounting Standards

Question: Whether in the form of U.S. GAAP or IFRS, financial accounting standards must be created in some logical fashion. Who is in charge of the production of formal accounting standards? How often do these official standards come into existence?

Answer: The Financial Accounting Standards Board (FASB) has held the authority to develop U.S. GAAP since 1973. An abundance of information can be found about this board and its activities by going to http://www.fasb.org/ and clicking on “About FASB.”

IFRS are produced by the London-based International Accounting Standards Board (IASB). This group took over responsibility for international standards from a predecessor group in 2001. Information about the resulting official pronouncements and the standard setting process is available at http://www.iasb.org/ by clicking on “About us.”

Although some basic elements of accounting standards have been in use almost throughout history, many reporting rules are relatively new—often developed within the last few decades. Whether U.S. GAAP or IFRS, accounting standards evolve quite quickly as the nature of business changes and new reporting issues, problems, and resolutions arise. The growth of advanced technology speeds this process even more quickly. Fairly important changes in the formal structure of accounting rules occur virtually every year.

In the United States, the existence of U.S. GAAP means that a business in Seattle, Washington, and a business in Atlanta, Georgia, must account for financial information in much the same manner. As will be discussed later in this textbook, a few allowed alternatives do exist in connection with specific reporting challenges.

Because standardization exists in most areas of the reporting process, any decision maker with an adequate knowledge of financial accounting—whether located in Phoenix, Arizona, or in Portland, Maine—should be able to understand the fairly presented financial information conveyed by a wide variety of organizations. They all speak the same language. Put simply, the existence of accounting standards enables organizations and other interested parties to communicate successfully.

TEST YOURSELF

Question:

An investor is studying a set of financial statements prepared for a company. He is considering buying some of its ownership shares. While studying the financial statements, he notices that they have been prepared in accordance with U.S. GAAP. Which of the following statements is true?

a. The rules and principles that make up U.S. GAAP have been the same now for over forty years.
b. The rules and principles that make up U.S. GAAP are consistent throughout the United States.
c. The rules and principles that make up U.S. GAAP are used consistently throughout the world.
d. The rules and principles that make up U.S. GAAP are the same as those used for income tax purposes.

Answer:

The correct answer is choice b: The rules and principles that make up U.S. GAAP are consistent throughout the United States.

Explanation:

U.S. GAAP provides a standardization of rules so that information can be better understood. These rules evolve rapidly; thus, much of U.S. GAAP is less than ten to fifteen years old. A different set of rules known as IFRS is used in much of the rest of the world and might eventually be applied in the United States. Income tax laws help governments raise revenues, a completely different purpose than U.S. GAAP. U.S. GAAP is designed to help organizations produce fairly presented financial statements.

The Importance of Accounting Standards

Question: Several years ago, a front page article in the Wall Street Journal *contained a controversial assessment of U.S. GAAP: "When the intellectual achievements of the 20th century are tallied, GAAP should be on everyone's Top 10 list. The idea of GAAP—so simple yet so radical—is that there should be a standard way of accounting for profit and loss in public businesses, allowing investors to see how a public company manages its money. This transparency is what allows investors to compare businesses as different as McDonald's, IBM* *and Tupperware, and it makes U.S. markets the envy of the world."*Clay Shirky, "How Priceline Became a Real Business," *Wall Street Journal*, August 13, 2001, A-12.

Could formal accounting standards be so very important? Can the development of U.S. GAAP possibly be one of the ten most important intellectual achievements of the entire twentieth century? A list of other accomplishments during this period includes air travel, creation of computers, birth of the Internet, landing on the moon, and the development of penicillin. With that level of competition, U.S. GAAP does not seem an obvious choice to be in the top ten. How can it be so important?

Answer: The United States has a capitalistic economy, which means that businesses are (for the most part) owned by private citizens and groups rather than by the government. To operate and grow, these companies must convince investors and creditors to contribute huge amounts of their own money voluntarily. Not surprisingly, such financing is only forthcoming if the possible risks and rewards can be assessed and then evaluated with sufficient reliability. Before handing over thousands or even millions of dollars, decision makers must believe that they are using reliable data to make reasonable estimations of future stock prices, cash dividends, and cash flows. Otherwise, buying stocks and granting credit is no more than gambling. As this quote asserts, U.S. GAAP enables these outside parties to obtain the financial information they need to reduce their perceived risk to acceptable levels. Thus, money can be raised, and businesses can grow and prosper.

Without U.S. GAAP, investors and creditors would encounter significant difficulties in evaluating the financial health and future prospects of an organization.The wide-scale financial meltdown in the world economy that began to be evident in 2008 put a serious strain on the traditional capitalist model. The United States and other governments had to spend billions of dollars to bail out (and, in some cases, take over) major enterprises. Whether U.S. GAAP could have done a better job to help avoid this calamity will probably not be fully known for years. Because of that uncertainty, they would be more likely to hold on to their money or invest only in other, safer options. Consequently, if accounting standards did not exist, the development and expansion of thousands of the businesses that have become a central part of today's society might be limited or impossible simply because of the lack of available resources. An expanding economy requires capital investment. That funding is more likely to be available when financial information can be understood because it is stated in a common language: U.S. GAAP.

By any method of measurement, the explosive development of the U.S. economy during the twentieth century (especially following World War II) has been spectacular, close to unbelievable. This growth has been fueled by massive amounts of money flowing from inside and outside the United States into the country's businesses. Much of the vitality of the U.S. economy results from the willingness of people to risk their money by buying capital stock or making loans or extending credit to such companies as **McDonald's**, **IBM**, and **Tupperware**. Without those resources, most businesses would be small or nonexistent, and the United States would surely be a radically different country.

The Evolution of Accounting Standards

Question: Accounting standards are important to businesses and decision makers alike. FASB is in charge of the creation of U.S. GAAP. As stated, all accounting standards tend to evolve over time. Official rules are modified, deleted, or added every year. How do new accounting standards come into existence?

Answer: As indicated earlier, since 1973, FASB has served as the primary authoritative body in charge of producing U.S. GAAP for nongovernmental entities such as businesses and private not-for-profit organizations. FASB is an independent group supported by the U.S. government, various accounting organizations, and many private businesses.

Typically, accounting problems arise over time within the various areas of financial reporting. New types of financial events can be created, for example, that are not covered by U.S. GAAP or, perhaps, weaknesses in earlier rules start to become evident. If such concerns grow to be serious, FASB steps in to study the issues and alternatives. After a period of study, the board might pass new rules or make amendments to previous ones. FASB is methodical in its deliberations, and the entire process can take years. Changes to U.S. GAAP are never made without proper consideration.

Several other official bodies also play important roles in the creation of U.S. GAAP. They are normally discussed in detail in upper-level accounting textbooks. However, the major authority for the ongoing evolution of U.S. GAAP lies with FASB and its seven-member board. It has released scores of official statements during its first four decades of existence. The impact that those rulings have had on U.S. GAAP and the financial reporting process in this country is almost impossible to overemphasize.

As just one example, FASB recently made a number of changes in the required reporting of receivables because of the chance that some (perhaps many) of these balances would not be collected. Possibly as a result of the current economic difficulties around the world, the members of FASB felt that more information was needed from organizations to inform decision makers about the risk involved with the collection of these receivables. This type of evolution takes place frequently in the language known as financial accounting. Whether U.S. GAAP or IFRS, financial accounting rules must be updated as needed to meet current informational needs.

In 2009, FASB combined all authoritative accounting literature into a single source for U.S. GAAP, which is known as the *Accounting Standards Codification*. By bringing together hundreds of authoritative documents, FASB has made U.S. GAAP both more understandable and easier to access. A multitude of pronouncements has been woven together in a logical fashion so that all rules on each topic are now gathered in one location.

KEY TAKEAWAY

No language can enable communication without some standardization of terminology and rules. At present, U.S. GAAP plays this role in the United States. The availability of these authoritative guidelines has served a central role in the growth of the U.S. economy since the end of the Great Depression and World War II. These uniform accounting rules allow investors and creditors to assess the possible risks and rewards they face. U.S. GAAP is constantly evolving as accountants seek better methods of providing financial information in an ever-changing business world. The main authority for the development of U.S. GAAP lies with the Financial Accounting Standards Board (FASB). FASB looks constantly for reporting issues that need to be studied so that needed changes can be made in official accounting rules. IFRS plays this same role in much of the rest of the world. The future of IFRS rules in the United States is yet to be determined, but acceptance of a single set of accounting standards in some form has many supporters.

Talking with an Independent Auditor about International Financial Reporting Standards

Robert A. Vallejo is a partner in the assurance (audit) practice of the public accounting firm **PricewaterhouseCoopers (PwC)**. Rob began his career with **PwC** in 1992 and has spent five years working in Europe (two in Paris and three in Amsterdam). Because of his time in Europe, he has extensive practical experience dealing with International Financial Reporting Standards (IFRS) and actively helps his U.S. clients understand the significant differences between U.S. accounting standards and IFRS. He currently works in the firm's Richmond, Virginia, office. Rob is the founder of the Philadelphia Chapter of ALPFA (the Association of Latino Professionals in Finance and Accounting) and is a member of the American Institute of Certified Public Accountants (AICPA) and the Virginia Society of CPAs.

Question: Over the past fifty years or so, the accounting profession in the United States has developed a very comprehensive set of official guidelines referred to collectively as U.S. GAAP. Recently, a strong push has developed to move away from those principles and adopt the pronouncements of the International Accounting Standards Board. If U.S. GAAP has worked successfully for so many years, why should we now think about abandoning it in favor of IFRS, a system that is not necessarily well understood in the United States?

Rob Vallejo: Economic events continue to illustrate how interrelated the world's economies really are. Therefore, it makes common sense that all companies around the world should report their financial information in accordance with the same set of accounting standards. For investors and creditors, it is hard to compare two companies that use different reporting standards unless the individual has a truly in-depth understanding of the differences. Unfortunately, both sets of standards are complex, which makes it very difficult to have a solid grasp of both. The United States is one of the few remaining jurisdictions that has not adopted IFRS, limiting the understanding and usefulness of our standards beyond our borders. Another argument in favor of the adoption of IFRS is the complexity of U.S. GAAP. It is a very rules-based set of standards that has evolved over many decades to address the ever-changing world of business, creating a maze of standards that is difficult to navigate. IFRS is more principles-based, allowing the preparers of financial information more judgment in applying general rules to a wide variety of situations. Lastly, U.S.

standard setters have become more involved in the evolution of IFRS. FASB has been working with the IASB in many instances to converge U.S. GAAP and IFRS even if formal adoption of IFRS never occurs in the United States.

Question: Rob, at key spots throughout this textbook, you have agreed to explain the impact that a possible change to IFRS will have on financial reporting in the United States. Obviously, the future is always difficult to anticipate with precision. However, what is your best guess as to when IFRS will start to be used in the financial statements issued by U.S. companies? At a basic level, as is appropriate in an introductory financial accounting course, how much real difference will be created by a change from U.S. GAAP to IFRS?

RV: The move to IFRS is being driven by the Securities and Exchange Commission (SEC), which has legal responsibility for much of the financial reporting in the United States. In 2008, the SEC published a road map that called for the largest U.S. publicly traded companies to publish their annual results for the year ending December 31, 2014, in accordance with IFRS. In February 2010, the SEC decided that IFRS would not be required of U.S. public companies prior to 2015 and, even then, only after additional study. A final decision is now expected from the SEC relatively soon, but the momentum leading to an inevitable switch to IFRS has subsided. Many believe that a much slower convergence approach, ensuring that all newly issued standards are the same under U.S. GAAP and IFRS, seems to be gaining traction. In general, any move to IFRS will not have a substantial impact on the financial information being reported by most U.S. companies. However, because of the many subtle differences between IFRS and U.S. GAAP, preparers of financial information have a lot of work to do to transition the reporting properly. As is the case many times, the devil is in the details.

Note: The role played in the U.S. economy by public accounting firms will be described in a later chapter. Some of these organizations have grown to an enormous size. According to its Web site as of July 14, 2011 (http://www.pwc.com/), **PricewaterhouseCoopers** employs approximately 161,000 individuals working in over 150 countries. During 2010, the firm earned in excess of $26 billion in revenues from customers as a result of the services that it rendered for them.

2.4 Four Essential Terms Encountered in Financial Accounting

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Define “asset” and provide examples found in financial reporting.
2. Define “liability” and provide examples found in financial reporting.
3. Define “revenue” and provide examples found in financial reporting.
4. Define “expense” and provide examples found in financial reporting.

Assets, Liabilities, Revenues, and Expenses

Question: Attaining a thorough understanding of financial accounting and its underlying standards is a worthwhile endeavor especially if a person hopes to become successful at making decisions about businesses or other organizations. Where should the journey to gain knowledge of financial accounting and its principles begin?

Answer: The study of a language usually starts with basic terminology. That is also an appropriate point of entry for an exploration into financial accounting. Consequently, four fundamental terms are introduced here in this section. Knowledge of these words is essential in gaining an understanding of accounting because they serve as the foundation for a significant portion of the financial information provided by any organization.

To illustrate, when examining the financial statements presented by **Sears** (formally known as **Sears Holdings Corporation**) for January 29, 2011, and the year then ended, four monetary balances immediately stand out because of their enormous size. On this date, the corporation reported $24.3 billion in **assets**[9] along with $15.6 billion in **liabilities**[10]. During that year, **Sears** generated **revenues**[11] of $43.3 billion and incurred **expenses**[12] of $43.2 billion.

- Assets
- Liabilities
- Revenues

9. Probable future economic benefits owned or controlled by an organization.

10. Probable future sacrifices of economic benefits arising from present obligations; the debts of an organization.

11. Measures of the increases in or inflows of net assets (assets minus liabilities) resulting from the sale of goods and services.

12. Measures of decreases in or outflows of net assets (assets minus liabilities) incurred in connection with the generation of revenues.

- Expenses

There are thousands of words and concepts found in accounting. No terms are more crucial to a comprehensive understanding of the reporting process than these four. Almost all discussions concerning financial information, whether practical or theoretical, come back to one or more of these words.

Definition of the Term "Asset"

Question: The first essential term presented here is "asset." Is an asset a complicated accounting concept? What general information is conveyed to a decision maker by the term "asset"?

Answer: Simply put, an asset is a probable future economic benefit that an organization either owns or controls.This is one of the opening chapters in an introductory financial accounting textbook. Definitions are somewhat simplified here so that they will be more understandable to students who are just beginning their exploration of accounting. Many terms and definitions will be expanded in later chapters of this textbook or in upper-level financial accounting courses. On January 29, 2011, **Sears** reported holding over $24.3 billion of these economic benefits. If a customer walks into one of the company's retail stores, many of these assets are easy to spot. The building itself may well be owned by **Sears** and certainly provides a probable future economic benefit by allowing the company to display merchandise and make sales. Other visible assets are likely to include cash registers, the cash held in those machines, available merchandise from jewelry to car tires to children's clothing (usually referred to as **inventory**[13] in financial accounting), shopping carts, delivery trucks, and the shelves and display cases. Each of those assets is acquired with the hope that it will help **Sears** prosper in the future.

Examples of Typical Assets

*Question: All decision makers who evaluate the financial health and future prospects of an organization should be interested in learning about its assets because those balances reflect the economic resources held at the present time. This is valuable information. What are some of the largest asset balances that a business like **Sears** is likely to report?*

13. A current asset bought or manufactured for the purpose of selling in order to generate revenue.

Answer: Every business has its own particular mix of assets. Virtually all have cash and accounts receivable (money due from customers). Many also have inventory (merchandise held for resale). The size and type of other assets will vary significantly based on the company and the industry in which it operates.

However, as a result of financial reporting and the existence of the Internet, such information is readily available to anyone wanting to learn about virtually any business. The assets are reported in the financial statements. As of January 29, 2011, the following four assets were reported by **Sears** as having the highest dollar amounts. Each of these asset categories will be discussed in detail later in this textbook.

Merchandise inventories	$9.1 billion
Buildings and improvements	$6.3 billion
Trade names and other intangible assets	$3.1 billion
Furniture, fixtures, and equipment	$2.9 billion

TEST YOURSELF

Question:

Alice Roanoke has decided to start an Internet business to provide expert financial advice to customers who sign up and pay a monthly fee. She hires Matt Showalter, a renowned expert in setting up investment strategies. She rents a building, paying for the next two years in advance. She also buys several large computers and a small library of books on investing and providing financial advice. Which of the following is not an asset to her new company?

a. Having Showalter as an employee
b. Owning the investment books
c. Paying the rent on the building for the subsequent two-year period
d. Acquiring the computers

Answer:

The correct answer is choice a: Having Showalter as an employee.

Explanation:

An asset is a future economic benefit that an organization owns or controls. A person cannot be owned or controlled and therefore is not deemed an asset for reporting purposes regardless of how smart or helpful the person is. Showalter could quit tomorrow. Company officials cannot force him to work for them; slavery was outlawed approximately 150 years ago. The books, the building, and the computers all have future economic benefit, and the company does have ownership or control.

Definition of the Term "Liability"

Question: As of January 29, 2011, ***Sears*** *also reports owing more than $15.6 billion in liabilities. Does this figure reflect the total amount that the reporting company will eventually have to pay to outside parties? What does the balance reported as liabilities represent?*

Answer: A more formal definition of a liability is that it is a probable future sacrifice of economic benefits arising from present obligations, but, for coverage here at the introductory level, liabilities can be viewed as the debts of the organization.

The $15.6 billion liability total disclosed by **Sears** most likely includes (1) amounts owed to the vendors who supply merchandise to the company's stores, (2) notes due to banks as a result of loans, (3) income tax obligations, and (4) balances to be paid to employees, utility companies, advertising agencies, and the like. The amount of such liabilities owed by many businesses can be staggering. **Walmart**, for example, disclosed approximately $109 billion in liabilities as of January 31, 2011. Even that amount pales in comparison to the $627 billion liability total reported by **General Electric** at the end of 2010. To ensure that a fairly presented portrait is shown to decision makers, businesses such as **Sears**, **Walmart**, and **General Electric** must make certain that the reported data contain no material misstatements. Thus, all the information that is provided about liabilities should be based on the rules and principles to be found in U.S. GAAP.

Another term that is often encountered in financial reporting is "net assets." The net asset total for an organization is simply its assets (future benefits) less its liabilities (debts). This balance is also known as "equity" in reference to the owners' rights to all assets in excess of the amount owed on liabilities. A business's net assets will increase if assets go up or if liabilities decrease. Changes in net assets show growth (or shrinkage) in the size of the organization over time. For example, **IBM** reported net assets of $22.7 billion at the end of 2009 (assets of $109.0 billion and liabilities of $86.3 billion). That number had risen to $23.2 billion by the end of 2010 (assets of $113.5 billion and liabilities of $90.3 billion). The ability of this business to increase its net assets by $500 million ($33.2 billion less $32.7 billion) during 2010 is certainly of interest to every decision maker analyzing the financial health and future prospects of **IBM**.

TEST YOURSELF

Question:

The Jackson Corporation is a women's clothing store located in Upper Lakeview. On Friday, the company's accountant is looking at four recent events so that the amount of liabilities can be reported as of the end of this week. Which of the following is not a liability for reporting purposes?

a. A new sales person was hired this morning, will begin work on the following Monday, and will be paid $600 per week.
b. Twenty dresses were received three days ago at a cost of $80 each, but they will not be sold until next week and payment will be made then.
c. The cost of renting the company's sales room is $1,300 per week, but the amount for this week will not be paid until next week.
d. The company borrowed $900,000 to build a new store, but construction will not start until next week.

Answer:

The correct answer is choice a: A new sales person was hired this morning, will begin work on the following Monday, and will be paid $600 per week.

Explanation:

With the dresses, the rent, and the loan, an event has already occurred that created an obligation. The dresses have been received, the room has been used, and money from the loan has been collected. In each case, the company has a debt. The new employee has not yet begun the job, so no debt has accrued. A commitment has been made to pay this person, but only if work is done. At that time, as the sales person works, the company does begin to have a debt (or liability) that must be reported.

Definition of the Term "Revenue"

Question: In financial accounting, a business or other organization reports its assets, which are probable future economic benefits, such as buildings, equipment, and cash. Liabilities (debts) are also included in the financial information being disclosed. Both of these terms seem relatively straightforward. The third essential term to be discussed at this time—revenue—is one that initially appears to be a bit less clear. Sears reported that its *stores generated revenues of $43.3 billion in 2010 alone. What does that tell a decision maker about Sears? What information is conveyed by the reporting of a revenue balance?*

Answer: "Revenue" is a measure of the financial impact on an organization that results from a particular process. This process is a sale. A customer enters a **Sears** store at the local mall and pays $100 to purchase several items, such as hammers, shirts, socks, and scarves. **Sears** receives an asset—possibly $100 in cash. This asset inflow into the business results from a sale and is called revenue. Revenue is *not* an asset; it is a measure of the increase in net assets created by the sale of inventory and services. Thus, for **The Coca-Cola Company**, revenues are derived (net assets are increased) from the sale of soft drinks. For **The Hershey Company**, revenues come from sales of chocolate whereas **The Walt Disney Company** generates revenue by selling admission to its amusement parks and movies.

For timing purposes, as will be discussed in a later chapter, revenue is recognized when the earning process takes place. That is normally when the goods or services are delivered. Therefore, throughout each day of the year, **Sears** makes sales to customers and accepts cash, checks, or credit card payments. The reported revenue figure is merely a total of all sales made during the period, clearly relevant information to any decision maker attempting to determine the financial prospects of this company. During 2010, the multitude of **Sears** stores located both inside and outside the United States sold inventory and services and received $43.3 billion in assets in exchange. That is the information communicated by the reported revenue balance. To reiterate, this figure is not exact, precise, accurate, or correct. However, according to **Sears**, $43.3 billion is a fairly presented total determined according to the rules of U.S. GAAP so that it contains no material misstatement. Any outside party analyzing **Sears** should be able to rely on this number with confidence in making possible finanical decisions about this business as a whole.

TEST YOURSELF

Question:

The Rowe Company is a restaurant in a remote area of Tennessee. The owner buys a steak from a local farmer for $7. The chef is paid $2 to cook this meat. A waitress is paid $1 to deliver the steak to a customer. The customer is charged $18, which is paid in cash. The customer leaves a tip for the waitress of $3. According to U.S. GAAP, what amount of revenue should the Rowe Company report in connection with this series of events?

a. $8
b. $10
c. $13
d. $18

Answer:

The correct answer is choice d: $18.

Explanation:

The term "revenue" refers to the increase in net assets brought into an organization as a result of a sale. There is a lot of interesting and relevant information here. However, only the payment made by the customer to the business is reported as revenue because that is the increase in net assets brought into the company by the sale.

TEST YOURSELF

Question:

The McCutcheon Company is a restaurant in a remote area of Montana. The owner buys a steak from a local farmer for $7. On Tuesday, the chef is paid $2 to cook this meat. A waitress is paid $1 to deliver the steak to a customer. The customer is charged $18. The customer does not have any money with him and tells the owner that he will pay the amount in the following week. The owner knows the customer and allows the payment to be delayed. According to U.S. GAAP, what amount of revenue should the McCutcheon Company report on Tuesday when the sale is made?

a. Zero
b. $8
c. $10
d. $18

Answer:

The correct answer is choice d: $18.

Explanation:

The term “revenue” refers to the increase in net assets as a result of the sale of a good or service. Here, the business received a promise to pay that is viewed as an asset because it has future economic benefit. Although no cash was collected, the business did gain an $18 asset (a receivable) as a result of the sale. Revenue was $18. Some very small organizations use cash systems that only recognize revenues when cash is received, but they are not reporting according to the rules of U.S. GAAP.

Definition of the Term “Expense”

Question: That leaves “expense” as the last of the four essential accounting terms introduced at this point. Sears reported $43.2 billion in total expenses during 2010. This figure apparently is important information that helps paint a proper portrait of the company, a portrait that can be used by decision makers. What is an expense?

Answer: An expense is an outflow or reduction in net assetsAn expense often causes an immediate reduction in assets, especially if cash is paid. Frequently, though, an expense creates an increase in liabilities instead of a reduction in assets. That happens if the cost is incurred but payment is delayed until a later date. In either case—the reduction of an asset or the creation of a liability—the amount of net assets held by the organization decreases as a result of the expense. that was incurred by an organization in hopes of generating revenue. To illustrate, assume that—at the end of a week—a local business pays its employees $12,000 for the work performed during the previous few days. A $12,000 salary expense must be reported. Cash (an asset) was reduced by that amount, and this cost was incurred because the company employed those individuals to help generate revenues. That is an expense. The same general logic can be applied in recording insurance expense, rent expense, advertising expense, utility expense (such as for electricity and water), and many other similar costs. For each, net assets are reduced (assets go down or liabilities go up) to help create sales.

In some ways, expenses are the opposite of revenues that measure the inflows or increases in net assets that are created by sales. Expense figures reflect outflows or decreases in net assets incurred in hopes of generating revenues.

TEST YOURSELF

Question:

The Hathaway Corporation started business on January 1, Year One, as a restaurant in Toledo, Ohio. During Year One, the company paid $10,000 each month to rent a building to serve as its kitchen and dining room. Because operations were so successful, on the final day of Year One, the company paid $150,000 to buy a new building for the restaurant. The company hopes to move over the New Year's Day holiday from the old rental facility to the newly acquired one. In connection with these events, how much should Hathaway report as its total expenses for Year One?

a. Zero
b. $120,000
c. $150,000
d. $270,000

Answer:

The correct answer is choice b: $120,000.

Explanation:

The company's net assets decreased by $10,000 per month as a result of renting the first space. The benefit from that rental has passed because the restaurant was used at that time to generate revenue. That is an expense. In contrast, the new building is an asset. In acquiring the building, one asset (cash) was exchanged for another (building). Net assets did not change; one asset went up and one went down. Thus, no expense resulted. The expense for Year One is $120,000 in rent.

Four Essential Terms Encountered in Financial Accounting

Question: To reiterate, four terms are basic to an understanding of financial accounting. Almost any coverage of accounting starts with these four. What is the meaning of asset, liability, revenue, and expense?

Answer:

- **Asset.** A probable future economic benefit owned or controlled by the reporting company, such as inventory, land, or equipment.
- **Liability.** A probable future economic sacrifice or, in simple terms, a debt.
- **Revenue.** A measure of the inflow or increase in net assets generated by the sales made by a business. It is a reflection of the amounts brought in by the sales process during a specified period of time.
- **Expense.** A measure of the outflow or reduction in net assets caused by a business's attempt to generate revenue and includes many common costs, such as rent expense, salary expense, and insurance expense.

KEY TAKEAWAY

A strong knowledge of basic accounting terminology is essential for successful communication to take place in the reporting of financial information. Four terms provide a foundational core around which much of the accounting process is constructed. Assets are probable future economic benefits owned or controlled by an organization. Assets typically include cash, inventory, land, buildings, and equipment. Liabilities are the debts of the reporting entity, such as salary payable, rent payable, and notes payable. Revenue figures indicate the increase in a company's net assets (its assets minus its liabilities) created by the sale of goods or services. Revenues are the lifeblood of any organization. Without the inflow of cash or receivables that comes from generating sales, a business cannot exist for long. Expenses are decreases in net assets that are incurred in hopes of generating revenues. Expenses incurred by most companies run a full gamut from rent and salary to insurance and electricity.

Talking with a Real Investing Pro (Continued)

Following is a continuation of our interview with Kevin G. Burns.

Question: Financial accountants tend to place a heavy emphasis on the importance of generally accepted accounting principles (U.S. GAAP) to the world of business. After nearly three decades as an investment advisor, what is your opinion of the relevance of U.S. GAAP?

Kevin Burns: Before the accounting scandals of the late 1990s—such as **Enron** and **WorldCom**—financial information that adhered to U.S. GAAP was trusted worldwide. Investors around the globe took comfort in a standard that had such a great reputation for integrity. In the 1990s, though, I felt that U.S. GAAP become somewhat muddied because investors wanted to depend too heavily on one or two figures rather than judging the company as a whole. In the last several years, FASB has moved back to stressing clearer transparency for reported information. That objective enables investors to better see and understand the organization standing behind those statements. That is very important in order to maintain investor confidence.

As for the current state of the U.S. GAAP, it is certainly superior to the majority of the world's standards. Unfortunately, it is getting more complicated every year, which is not always a good goal.

Question: Your answer is quite interesting because of the push in recent years toward International Financial Reporting Standards as a single global set of standards for all businesses. Some people love the idea of the same accounting rules for everyone. Others hate the idea that IFRS could replace U.S. GAAP. What is your feeling?

KB: For an investor, that is a very interesting question. Given that we truly are a global economy I would love a worldwide standard but only if it was equal to or more transparent than the current U.S. standards. As an investment advisor, I would love to be able to compare business valuations here and in China (for example) side by side and have confidence that I am truly comparing apples to apples.

Question: When you begin to study the financial data reported by a company that you are analyzing as an investment possibility, which do you look at first: revenues, expenses, assets, or liabilities?

KB: For me, assets have always been the most important determination in the investments that I have chosen. However, that is because I have always been strictly a value investor. There are many different styles of investing. Value investors look at the value of a company's assets and then look for bargains based on current stock market prices. In comparison, growth investors look at earnings momentum and don't care too much about asset values. They like to see a consistent rise in profitability each year. Over the years, being a value investor has worked well for my clients and me.

Video Clip

(click to see video)

Professor Joe Hoyle talks about the five most important points in Chapter 2 "What Should Decision Makers Know in Order to Make Good Decisions about an Organization?".

2.5 End-of-Chapter Exercises

QUESTIONS

1. Why is the information reported by financial accounting not necessarily correct or accurate?
2. What is a misstatement?
3. In reference to a misstatement, what is meant by materiality?
4. How is materiality determined?
5. When is a misstatement considered fraud?
6. Provide several examples of uncertainties faced by businesses that can impact the financial reporting process.
7. Why is financial accounting compared to the painting of a portrait?
8. Why is financial accounting compared to a language?
9. What is U.S. GAAP and how has U.S. GAAP developed over the years?
10. Why is U.S. GAAP so important to the capital market system in the United States?
11. Why is there a push to accept International Financial Reporting Standards (IFRS) as the universal standards for financial accounting?
12. Define “asset” and give several examples.
13. Define “liability” and give several examples.
14. What is meant by the term “net assets?”
15. Define “revenue.”
16. Define “expense.”

TRUE OR FALSE

1. ____ Most countries require companies that operate within their borders to follow U.S. GAAP in preparing their financial statements.
2. ____ Companies face many uncertainties when preparing their financial statements.
3. ____ If a company reports equipment costing $122,756,255, that is the amount that it actually did cost.
4. ____ A liability is defined as a probable future economic benefit that an organization owns or controls.
5. ____ Creation of U.S. GAAP is primarily done by the U.S. government.
6. ____ IFRS has been in wide use in many countries since 1976.
7. ____ In order for investors to properly evaluate the financial information of a business or other organization, it is vital that the financial information be exact.
8. ____ A corporation reports sales of $33,453,750 when the actual figure was $33,453,843. This information contained a misstatement.
9. ____ Materiality depends on the size of the organization.
10. ____ A material misstatement that is made in a set of financial statements is acceptable as long as there is only one.
11. ____ A misstatement has to be caused by fraud.
12. ____ The reporting of a pending lawsuit is relatively simple.
13. ____ One business has a misstatement of $10,000 that is caused by fraud. It also has another misstatement of $10,000 that is caused by error. If one of these misstatements is material, then they both are.
14. ____ Only accountants need to understand the terminology that is found in accounting.
15. ____ For a business or other organization, an employee is an example of an asset.
16. ____ A sales transaction is normally considered revenue even if cash is not collected until the following year.
17. ____ The purchase of a building for $2.4 million is recorded as an expense.

MULTIPLE CHOICE

1. Which of the following is not an example of an uncertainty that companies often face in their financial reporting?

    a. Sales that have not yet been collected in cash
    b. Warranties
    c. A loan due to a bank
    d. A lawsuit that has been filed against the company

2. Which of the following is true about U.S. GAAP?

    a. U.S. GAAP has been developed over the past ten years.
    b. U.S. GAAP allows financial statement users to compare the financial information of companies around the world.
    c. U.S. GAAP helps accountants achieve an exact presentation of a company's financial results.
    d. U.S. GAAP helps investors and creditors evaluate the financial health of a business.

    Questions 3, 4, and 5 are based on the following:

    Mike Gomez owns a music store called Mike's Music and More. The store has inventory for sale that includes pianos, guitars, and other musical instruments. Mike rents the building in which his store is located, but owns the equipment and fixtures inside it. Last week, Mike's Music made sales of $3,000. Some of the sales were made in cash. Some were made to customers who have an account with Mike's Music and are billed at the end of the month. Last month, Mike's Music borrowed $10,000 from a local bank to expand the amount of inventory being sold.

3. Which of the following is not an asset owned by Mike's Music?

    a. The inventory of musical instruments
    b. The building in which the store is located
    c. The amount owed to Mike's Music by its customers
    d. The equipment and fixtures in the store

4. Which of the following is a liability to Mike's Music?

a. The loan amount that must be repaid to the bank
b. The amount owed to Mike's Music by its customers
c. The sales Mike's Music made last week
d. The cash collected from customers on the sales made last week

5. Which of the following statements is true?

a. Mike's Music is too small for any outside party to care about its financial information.
b. The sales Mike's Music made last week are considered revenue.
c. The intent of Mike's Music to expand is an asset.
d. The sales Mike's Music made on credit last week is viewed as a liability.

6. The Acme Company reports financial information to potential investors. The information is said to be "presented fairly according to U.S. GAAP." What does that mean?

a. The information contains no material misstatements according to the rules and standards of U.S. GAAP.
b. The information is correct and follows the rules of U.S. GAAP.
c. The information contains neither errors nor fraudulent numbers as specified by U.S. GAAP.
d. The information is comparable to that reported by other companies around the world.

7. Which of the following statements is true?

a. Accounting rules referred to as IFRS are more complex than those existing within U.S. GAAP.
b. Accounting rules referred to as IFRS have been developed for as long a period of time as the rules that make up U.S. GAAP.
c. Accounting rules referred to as IFRS have become dominant in the world of accounting outside of the United States.
d. Accounting rules referred to as IFRS will become mandatory in the United States in 2014.

8. The Remingshire Corporation paid $2,000 at the end of the week to employees who worked for the business during that week. The corporation also paid another $3,000 at the end of the week for rent on the retail space that was occupied that week. Which of the following statements is true?

    a. The $2,000 is an expense for this period, but the $3,000 is not.
    b. The $3,000 is an expense for this period, but the $2,000 is not.
    c. Neither the $2,000 nor the $3,000 is an expense for this period.
    d. Both the $2,000 and the $3,000 are expenses for this period.

9. Officials for the Boston Company have just borrowed $25,000 on a three-year loan from a bank. Which of the following is true?

    a. The company has an expense as a result of this transaction.
    b. The company’s net assets have gone down as a result of this transaction.
    c. The company’s net asserts have gone up as a result of this transaction.
    d. No change took place in this company’s net assets as a result of this transaction.

VIDEO PROBLEMS

Professor Joe Hoyle discusses the answers to these two problems at the links that are indicated. After formulating your answers, watch each video to see how Professor Hoyle answers these questions.

1. Your roommate is an English major. The roommate knows that you are taking a course in financial accounting. The roommate has never once considered taking a class in business and is interested in what you are learning. One evening, while listening to some music on the Internet, you mention that financial accounting is a type of language. The roommate is completely baffled by this assertion and wants to know how anything in accounting could possibly resemble a language such as English. How would you respond?

(click to see video)

2. Your uncle has worked for a large office supply business for the past twenty years. He is responsible for a small team of employees who do the interior design work for each of the company's stores located around the country. One day he sends you the following e-mail:. "As a reward for twenty years of service, my company has offered to sell me one thousand shares of their capital stock for $23 per share. That's $23,000, and that is a lot of money. I've never been interested in this aspect of business, but I don't want to make a dumb decision. The company furnished me with a set of financial statements that are just full of numbers and odd terms. At one point, I found a statement that this information was presented fairly in conformity with U.S. Generally Accepted Accounting Principles. I understand you are taking a financial accounting course in college. What is meant by 'presented fairly'? What is meant by 'U.S. Generally Accepted Accounting Principles'? Most important, why is this important to me as I look through financial statements in hopes of making a good decision?"

(click to see video)

PROBLEMS

1. Mark each of the following with an (A) to indicate it is an asset, an (L) to indicate it is a liability, an (R) to indicate it is revenue, or an (E) to indicate it is an expense.

    a. ____ Cash
    b. ____ Building
    c. ____ Loan due to the bank
    d. ____ Inventory
    e. ____ Salary expense
    f. ____ Rent expense
    g. ____ Amounts owed to employees for work done
    h. ____ Equipment
    i. ____ Amounts owed to suppliers
    j. ____ Sales

2. For each of the following, indicate at least one area of uncertainty that would impact the financial reporting of the balance.

    a. Inventory
    b. Receivable from a customer
    c. Equipment
    d. Income taxes payable
    e. Liability from lawsuit

3. The Winslow Corporation operates a jewelry store in Topeka, Kansas. The business has recently issued a set of financial statements. One asset, inventory, was reported at $1.5 million. Later, it was determined that this balance was misstated. Describe several reasons why this misstatement might have happened.

4. For each of the following events, indicate whether the net assets of the reporting company increase, decrease, or remain the same.

    a. The company owes $1,000 for some purchases made last month and pays that amount now.
    b. The company borrows $220,000 from a bank on a loan.
    c. The company sells a service to a customer for $30,000 with payment made immediately.

d. The company sells a service to a customer for $40,000, but payment will not be made for several months.
e. The company pays $8,000 in cash for several pieces of equipment.
f. The company rented a large truck for one day for $500, which it paid at the end of the work day.

RESEARCH ASSIGNMENTS

1. Go to http://www.aboutmcdonalds.com/. At the **McDonald's** Web site, click on "Investors" at the left of the page. Click on "Annual Reports" on the right of the next screen. Finally, click on "2010 Annual Report" to download. Answer the following questions:

   a. On page 26 of the 2010 annual report for **McDonald's**, you will see a list of revenues and expenses. What is the largest revenue and what is the amount? What is the largest expense and what is the amount?
   b. On page 27 of the 2010 annual report for **McDonald's**, you will see a list of assets and liabilities. What is the largest asset and what is the amount? What is the largest liability and what is the amount?

2. **IBM Corporation** provides information about accounting to help decision makers understand the financial statements that the business provides. Go to the following URL and read the sections presented on "Assets" and on "Liabilities."

   http://www.ibm.com/investor/help/guide/statement-basics.wss#assets

   For the coverage of assets, and then also for liabilities, list two pieces of information that you already knew based on the coverage here in Chapter 2 "What Should Decision Makers Know in Order to Make Good Decisions about an Organization?". Next, list one piece of information about both assets and liabilities that you learned from the **IBM** essay.

3. Go to http://www.google.com/finance/. In the box labeled "Get quotes," enter "**Johnson & Johnson**." On the page that appears, scroll down and find "Investor Relations" on the right side. Click on that link and then click on "Annual Reports" on the left side of the next page. Click on "2010 Annual Report" in the middle of the next page that appears. After the annual report downloads, scroll to page 41. You should find a listing of the company's assets and liabilities.

a. What is the total amount reported for the company's assets?
b. What is the total amount reported for the company's liabilities?
c. Determine the net assets for **Johnson & Johnson**.