

A hand wearing a white work glove is shown from the wrist up, holding a yellow and black tool, possibly a wrench or a similar mechanical device. The hand is positioned in the upper right quadrant of the frame. The background is a scenic view of a mountain range with snow-capped peaks under a clear blue sky. The overall image has a professional and industrial feel.

KIMMEL • WEYGANDT • KIESO

FINANCIAL

TOOLS FOR BUSINESS DECISION MAKING

ACCOUNTING

Fourth Edition

Financial Accounting

Tools for Business Decision Making
4th Edition

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Matt, Erin, and Lia; and Douglas and Debra

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Introduction to Financial Statements

STUDY OBJECTIVES

After studying this chapter, you should be able to:

- 1 Describe the primary forms of business organization.
- 2 Identify the users and uses of accounting information.
- 3 Explain the three principal types of business activity.
- 4 Describe the content and purpose of each of the financial statements.
- 5 Explain the meaning of assets, liabilities, and stockholders' equity, and state the basic accounting equation.
- 6 Describe the components that supplement the financial statements in an annual report.

 **THE NAVIGATOR**

FEATURE STORY



Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" In response, consider this quote from Harold Geneen, the former chairman of IT&T: "To be good at your business, you have to know the numbers—cold." Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting and financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

Many companies spend significant resources teaching their employees basic accounting so that they can read financial statements and understand how their actions affect the company's financial results. One such company is Springfield ReManufacturing Corporation (SRC). When Jack Stack and 11 other managers purchased SRC for 10 cents a share, it was a failing division of International Harvester. Jack had 119 employees who were counting on him for their livelihood, and he knew that the new company was on the verge of financial failure. He

THE NAVIGATOR

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● Read <i>Feature Story</i>	<input type="checkbox"/>
● Read <i>Preview</i>	<input type="checkbox"/>
● Read text and answer <i>Before You Go On</i> p. 11 <input type="checkbox"/> p. 17 <input type="checkbox"/> p. 24 <input type="checkbox"/>	
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decided that the only chance of survival was to encourage every employee to think like a businessperson and to act like an owner. To accomplish this, all employees at SRC took basic accounting courses and participated in weekly reviews of the company's financial statements. SRC survived, and eventually thrived. To this day, every employee (now numbering more than 1,000) undergoes this same training.

Many other companies have adopted this approach, which is called "open-book management." Even in companies that do not practice open-book management, employers generally assume that managers in all areas of the company are "financially literate."

Taking this course will go a long way to making you financially literate. In this book you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. In this first chapter we will introduce you to the financial statements of a real company whose products you are probably familiar with—Tootsie Roll. Tootsie Roll's presentation of its financial results is complete, yet also relatively easy to understand.

Tootsie Roll started off humbly in 1896 in a small New York City candy shop owned by an Austrian immigrant, Leo Hirshfield. The candy's

name came from his five-year-old daughter's nickname—"Tootsie." Today the Chicago-based company produces more than 49 million Tootsie Rolls and 16 million Tootsie Pops *each day*. In fact, Tootsie Pops are at the center of one of science's most challenging questions: How many licks does it take to get to the Tootsie Roll center of a Tootsie Pop? The answer varies: Licking machines created at Purdue University and the University of Michigan report an average of 364 and 411 licks, respectively. In studies using human lickers, the answer ranges from 144 to 252. We recommend that you take a few minutes today away from your studies to determine your own results.

Source: Tootsie Roll information adapted from www.tootsie.com.

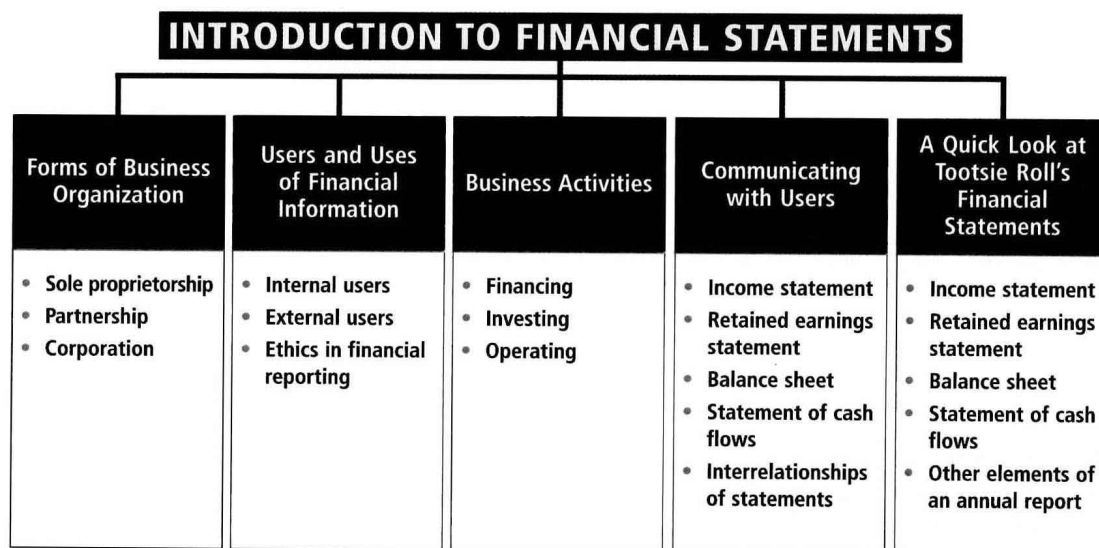
On the World Wide Web
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Corporation:
www.screman.com
Tootsie Roll Industries:
www.tootsie.com

THE
NAVIGATOR

PREVIEW OF CHAPTER 1

How do you start a business? How do you make it grow into a widely recognized brand name like Tootsie Roll? How do you determine whether your business is making or losing money? When you need to expand your operations, where do you get money to finance expansion—should you borrow, should you issue stock, should you use your own funds? How do you convince lenders to lend you money or investors to buy your stock? Success in business requires making countless decisions, and decisions require financial information.

The purpose of this chapter is to show you what role accounting plays in providing financial information. The content and organization of the chapter are as follows.



Forms of Business Organization

STUDY OBJECTIVE

1

Describe the primary forms of business organization.

Suppose you graduate with a marketing degree and open your own marketing agency. One of your initial decisions is what organizational form your business will have. You have three choices—sole proprietorship, partnership, or corporation. A business owned by one person is a **sole proprietorship**. A business owned by two or more persons associated as partners is a **partnership**. A business organized as a separate legal entity owned by stockholders is a **corporation**.

You will probably choose the sole proprietorship form for your marketing agency. It is **simple to set up** and **gives you control** over the business. Small owner-operated businesses such as barber shops, law offices, and auto repair shops are often sole proprietorships, as are farms and small retail stores.

Another possibility is for you to join forces with other individuals to form a partnership. Partnerships often are formed because one individual does not have **enough economic resources** to initiate or expand the business. Sometimes **partners bring unique skills or resources** to the partnership. You and your

Terms that represent essential concepts are printed in blue. They are listed and defined again in the **glossary** at the end of the chapter.

partners should formalize your duties and contributions in a written partnership agreement. Retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants), often organize as partnerships.

As a third alternative, you might organize as a corporation. As an investor in a corporation you receive shares of stock to indicate your ownership claim. Buying stock in a corporation is often more attractive than investing in a partnership because shares of stock are **easy to sell** (transfer ownership). Selling a proprietorship or partnership interest is much more involved. Also, individuals can become **stockholders** by investing relatively small amounts of money. Therefore, it is **easier for corporations to raise funds**. Successful corporations often have thousands of stockholders, and their stock is traded on organized stock exchanges like the New York Stock Exchange. Many businesses start as sole proprietorships or partnerships and eventually incorporate. For example, in 1896 Leo Hirshfield started Tootsie Roll as a sole proprietorship, and by 1919 the company had incorporated.

Other factors to consider in deciding which organizational form to choose are **taxes and legal liability**. If you choose a sole proprietorship or partnership, you generally receive more favorable tax treatment than a corporation. However, proprietors and partners are personally liable for all debts of the business; corporate stockholders are not. In other words, corporate stockholders generally pay higher taxes but have no personal liability. We will discuss these issues in more depth in a later chapter. Illustration 1-1 highlights the three types of organizations and the advantages of each.

Alternative Terminology
notes present synonymous terms that you may come across in practice.

Alternative Terminology
Stockholders are sometimes called *shareholders*.

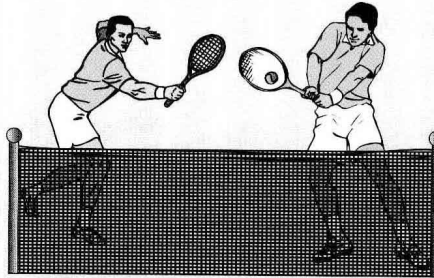
Illustrations like this one convey information in pictorial form to help you visualize and apply the ideas as you study.

Illustration 1-1 Forms of business organization



Sole Proprietorship

- Simple to establish
- Owner controlled
- Tax advantages



Partnership

- Simple to establish
- Shared control
- Broader skills and resources
- Tax advantages



Corporation

- Easier to transfer ownership
- Easier to raise funds
- No personal liability

The combined number of proprietorships and partnerships in the United States is more than five times the number of corporations. However, the revenue produced by corporations is eight times greater. Most of the largest enterprises in the United States—for example, Coca-Cola, ExxonMobil, General Motors, Citigroup, and Microsoft—are corporations. Because the majority of U.S. business

is transacted by corporations, the emphasis in this book is on the corporate form of organization.

Users and Uses of Financial Information

STUDY OBJECTIVE

2

Identify the users and uses of accounting information.

The purpose of financial information is to provide inputs for decision making. **Accounting** is the information system that identifies, records, and communicates the economic events of an organization to interested users. Many people have an interest in knowing about the ongoing activities of the business. These people are **users** of accounting information. Users can be divided broadly into two groups: internal users and external users.

INTERNAL USERS

Internal users of accounting information are managers who plan, organize, and run a business. These include **marketing managers, production supervisors, finance directors, and company officers**. In running a business, managers must answer many important questions, as shown in Illustration 1-2.

Illustration 1-2

Questions Asked by Internal Users



Finance

Is cash sufficient to pay dividends to Microsoft stockholders?



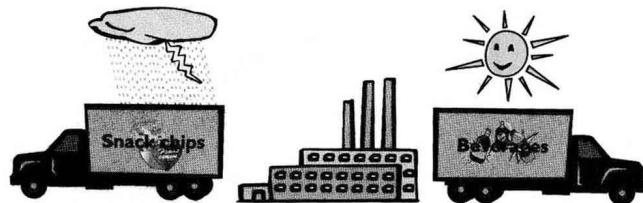
Marketing

What price for an Apple iPod will maximize the company's net income?



Human Resources

Can we afford to give General Motors employees pay raises this year?



Management

Which PepsiCo product line is the most profitable? Should any product lines be eliminated?

To answer these and other questions, you need detailed information on a timely basis. For internal users, accounting provides internal reports, such as financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year. In addition, companies present summarized financial information in the form of financial statements.

Accounting across the Organization

Accounting can even serve as a useful recruiting tool for the human resources department. Rhino Foods, located in Burlington, VT, is a manufacturer of specialty ice cream novelties and ice cream ingredients. Its corporate website includes the following paragraphs:

"Wouldn't it be great to work where you were part of a team? Where your input and hard work made a difference? Where you weren't kept in the dark about what management was thinking?"

Well—it's not a dream! It's the way we do business at Rhino Foods on Industrial Parkway in Burlington. Rhino Foods believes in family, honesty and open communication—we really care about and appreciate our employees—and it shows. Operating results are posted and monthly group meetings inform all employees about what's happening in the Company. Employees also share in the Company's profits, in addition to having an excellent comprehensive *benefits* package."

Source: www.rhinofoods.com/workforus/workforus.html.



What are the benefits to the company and to the employees of making the financial statements available to all employees?

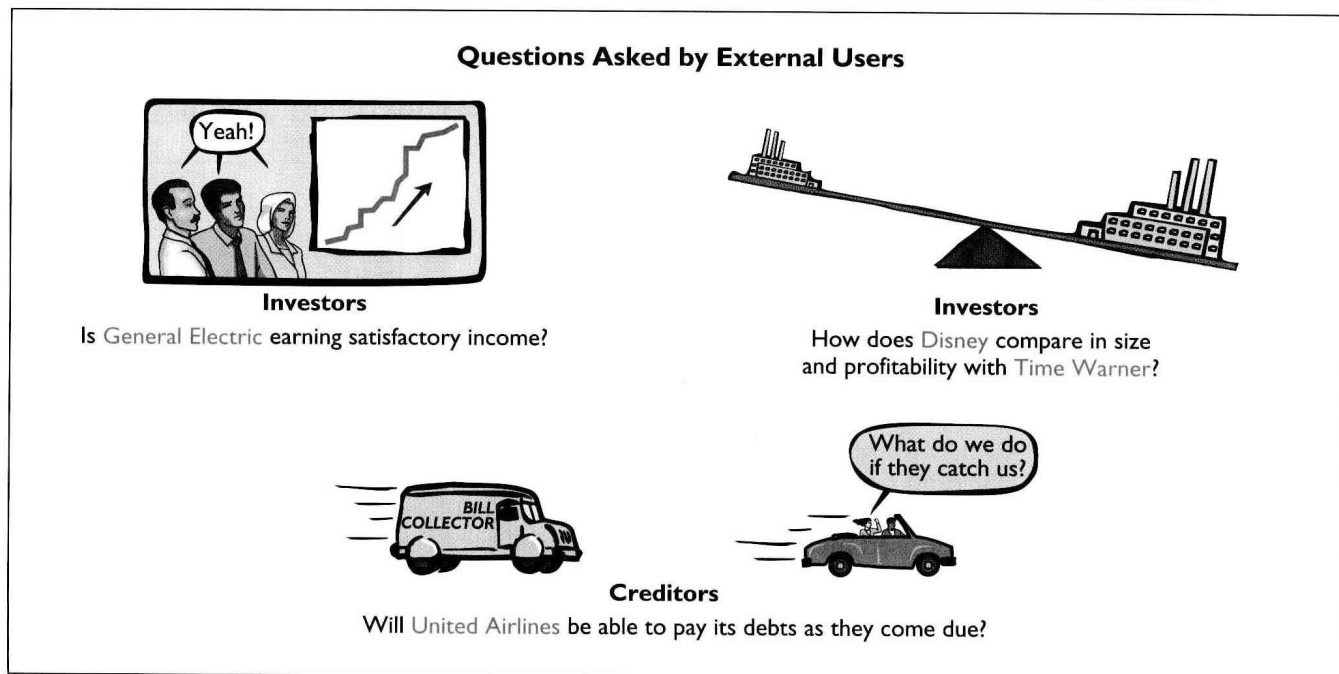
Accounting across the Organization stories demonstrate applications of accounting information in various business functions.

EXTERNAL USERS

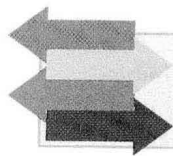
There are several types of **external users** of accounting information. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell stock. **Creditors** such as suppliers and bankers use accounting information to evaluate the risks of granting credit or lending money. Some questions that investors and creditors may ask about a company are shown in Illustration 1-3.

The information needs and questions of other external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with the tax laws. **Customers** are interested in whether a

Illustration 1-3



company like General Motors will continue to honor product warranties and otherwise support its product lines. **Labor unions** such as the Major League Baseball Players Association want to know whether the owners have the ability to pay increased wages and benefits. **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules. For example, Enron, Dynegy, Duke Energy, and other big energy-trading companies reported record profits at the same time as California was paying extremely high prices for energy and suffering from blackouts. This disparity caused regulators to investigate the energy traders to make sure that the profits were earned by legitimate and fair practices.



Accounting across the Organization



One question that students of accounting frequently ask is, “How will the study of accounting help me?” It should help you a great deal, because a working knowledge of accounting is desirable for virtually every field of endeavor. Some examples of how accounting is used in other careers include:

General management: Imagine running Ford Motors, Massachusetts General Hospital, California State University–Fullerton, a McDonald’s franchise, a Trek bike shop. All general managers need to understand accounting data in order to make wise business decisions.

Marketing: A marketing specialist at a company like Procter & Gamble develops strategies to help the sales force be successful. But making a sale is meaningless unless it is a profitable sale. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

Finance: Do you want to be a banker for Citicorp, an investment analyst for Goldman Sachs, a stock broker for Merrill Lynch? These fields rely heavily on accounting. In all of them you will regularly examine and analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for Prudential Real Estate? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?



How might accounting help you?

ETHICS IN FINANCIAL REPORTING

People won’t gamble in a casino if they think it is “rigged.” Similarly, people won’t “play” the stock market if they think stock prices are rigged. In recent years the financial press has been full of articles about financial scandals at Enron, WorldCom, HealthSouth, and AIG. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing. One article in the *Wall Street Journal* noted that “repeated disclosures about questionable accounting practices have bruised investors’ faith in the reliability of earnings reports, which in turn has sent stock prices tumbling.”¹ Imagine trying to carry on a business or invest money

¹“U.S. Share Prices Slump,” *Wall Street Journal* (February 21, 2002).

if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

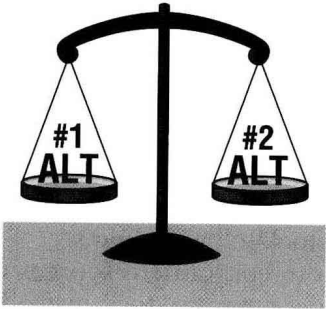
United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In 2002 Congress passed the **Sarbanes-Oxley Act (SOX)** to try to reduce unethical corporate behavior and consequently decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for fraudulent financial activity by top management are now much more severe. Also, SOX calls for increased independence of the outside auditors who review the accuracy of corporate financial statements, and increased responsibility of boards of directors in their oversight role.

Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this book: (1) A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting. (2) *Business Insight boxes* with an ethics perspective highlight ethics situations and issues in actual business settings. (3) At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision maker in that case. (4) The CD that accompanies this book has video segments on critical accounting issues.

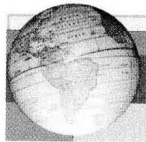
When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in Illustration 1-4.

Illustration 1-4 Steps in analyzing ethics cases

Solving an Ethical Dilemma



- 1. Recognize an ethical situation and the ethical issues involved.**
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.
- 2. Identify and analyze the principal elements in the situation.**
Identify the *stakeholders*—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?
- 3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.**
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require you to evaluate each alternative and select the best one.



Business Insight International Perspective

Concern over the quality and integrity of financial reporting is not limited to the United States. Recently the Chinese Ministry of Finance reprimanded a large accounting firm for preparing fraudulent financial reports for a number of its publicly traded companies. Afterward, the state-run news agency noted that investors and analysts actually felt that the punishment of the firm was not adequate. In fact, a recent survey of investors in China found that less than 10 percent had full confidence in companies' annual reports. As a result of these concerns the Chinese Institute of Certified Public Accountants vowed to strengthen its policing of its members.



What has been done in the United States to improve the quality and integrity of financial reporting and to build investor confidence in financial reports?



Business Insights provide examples of business situations from various perspectives—ethics, investor, and international.