

CHAPTER 1

ACCOUNTING: INFORMATION FOR DECISION MAKING

OVERVIEW OF BRIEF EXERCISES, EXERCISES, AND CRITICAL THINKING CASES

Brief Exercises	Topic	Learning Objectives	Skills
B. Ex. 1.1	Users of accounting information	1, 3, 5	Analysis
B. Ex. 1.2	Components of internal control	2, 5	Analysis
B. Ex. 1.3	Inexact or approximate measures	3, 4	Analysis, judgment
B. Ex. 1.4	Standards for the preparation of accounting information	5, 6	Analysis
B. Ex. 1.5	FASB conceptual framework	1, 3, 5, 6	Analysis
B. Ex. 1.6	PCAOB	5, 6	Analysis, research
B. Ex. 1.7	COSO	2, 5, 6	Analysis, ethics
B. Ex. 1.8	Professional certifications in accounting	7, 8	Analysis
B. Ex. 1.9	AICPA code of professional conduct	5, 7	Analysis, ethics
B. Ex. 1.10	Personal benefits of accounting skills	1	Analysis

Exercises	Topic	Learning Objectives	Skills
1.1	You as a user of accounting information	1	Analysis, judgment
1.2	Real World: Boeing Company, California Public Employees Retirement System, China Airlines Users of accounting information	3, 4	Analysis, research
1.3	What is financial reporting?	3	Analysis, judgment
1.4	Generally accepted accounting principles	6	Analysis
1.5	Accounting organizations	6	Analysis, communication
1.6	Investment return	3	Analysis
1.7	Accounting terminology	3-5, 7	Analysis
1.8	Accounting organizations	6	Analysis
1.9	Financial and management accounting	3, 4	Judgment
1.10	Management accounting information	4	Communication, judgment
1.11	Accounting organizations	6	Analysis, judgment
1.12	Purpose of an audit	5	Analysis, judgment
1.13	Audits of financial statements	5	Analysis
1.14	Ethics and professional judgment	7	Analysis, communication, judgment
1.15	Careers in accounting	8	Judgment, communication
1.16	Home Depot, Inc. general information	1, 3, 5	Analysis, judgment, research

Due to the introductory nature of this chapter and the conceptual nature of its contents, no items labeled **Problems** are included. In all future chapters you will find a series of Problems that generally include computations, are more complex, and generally require more time to complete than Exercises.

Critical Thinking Cases

1.1	Real World: Fannie Mae Reliability of financial statements	5	Analysis, ethics, judgment
1.2	Objectives of financial accounting	3	Analysis, communication, group, judgment
1.3	Accounting systems	2	Analysis, communication
1.4	Codes of ethics (Ethics, fraud, and corporate governance)	7	Analysis, communication, judgment
1.5	Accessing information on the Internet (Internet)	6, 7	Research, technology

DESCRIPTIONS OF CRITICAL THINKING CASES

Below are brief descriptions of each case. These descriptions are accompanied by the estimated time (in minutes) required for completion and by a difficulty rating.

Critical Thinking Cases

- | | | |
|------------|--|------------------|
| 1.1 | Fannie Mae
Reliability of Financial Statements
This case explores the general subject of integrity in financial statements—what causes potential investors to be able to rely on information and what precludes management from portraying a company in more positive terms than it should. | 15 Easy |
| 1.2 | Objectives of Financial Accounting
Characteristics of accounting and accounting information (e.g., useful for decision making, language of business) are used to explain the importance of accounting information. | 15 Medium |
| 1.3 | Accounting Systems
The purpose and functions of accounting systems are covered, as well as the definition of what an accounting system is and who is responsible for designing and implementing accounting systems. | 15 Easy |
| 1.4 | Codes of Ethics
Ethics, Fraud, and Corporate Governance
Students are placed in the position of a new employee who is faced with the challenge of becoming familiar with an appropriate code of ethics and must think through how that code might influence his/her behavior on the job. | 30 Medium |
| 1.5 | Accessing Information on the Internet
Internet
Students are introduced to learning on the Internet by accessing the Rutgers University web page on accounting information. Once there, they learn about accounting firms, accounting textbook publishers, and professional accounting organizations. | 30 Medium |

SUGGESTED ANSWERS TO DISCUSSION QUESTIONS

Note to instructor: We regularly include discussion questions as part of the assigned homework. One objective of these questions is to help students develop communications skills; however, we find that they also increase students' conceptual understanding of accounting.

1. Accounting is a way of communicating the results of business activity and, therefore, is sometimes described as the language of business. Among the important accounting measurements that communicate business activity and justify describing accounting as the language of business are costs, prices, sales volume, profits, and return on investment.
2. The return of your investment is the repayment to you of the amount you invested earlier. The return on your investment is what the company pays you for having the use of your money while it was invested as opposed to your having use of the money while it was invested.
3. The three primary objectives of financial reporting, from general to specific, are to provide:
 - Information that is useful in making investment and credit decisions.
 - Information useful in assessing the amount, timing, and uncertainty of future cash flows.
 - Information about economic resources, claims to resources, and changes in resources and claims on them.
4. The three primary financial statements that are the means of communicating financial accounting information are:
 - Statement of financial position (balance sheet)—A statement that shows where the company stands at a point in time.
 - Income statement—A statement that details the results of the company's profit-seeking activities during a period of time.
 - Statement of cash flows—A statement that presents details of the company's cash balance—how it increased, how it decreased, and how the ending balance compares with the beginning balance—for a period of time.
5. While financial information has an appearance of precision, it often requires judgment and estimation and, thus, is less precise than one might think. For example, to determine certain information about a company for a certain year, or at a certain point in time, it may be necessary to make estimates about the future. Those estimates may or may not turn out, in the long term, to be precisely correct. This causes information about the current year to be less precise and accurate than would otherwise be the case.
6. Internal accounting information is primarily oriented toward the future. While some management accounting information is historical, the purpose of management accounting information is to facilitate current and future decision making that is in the best interests of the company and that is consistent with the company's mission. Financial accounting information, while also used for current and future decision making, is generally more historical in nature than is management accounting. Financial accounting information deals primarily with the financial activities of the enterprise during recent past periods.
7. Generally accepted accounting principles are agreed-upon ways that economic activity will be captured and reported in monetary terms. They are important in insuring the integrity of financial accounting information and being able to compare the information of one enterprise with that of another enterprise.

8. *Internal control* is a process designed to provide reasonable assurance that the organization produces reliable financial reports, complies with applicable laws and regulations, and conducts operations in an efficient and effective manner. The five components of internal control per the COSO framework are the control environment, risk assessment, control activities, information and communication, and monitoring.
9. An audit is an examination of a company's financial information, including financial statements, by an independent expert (e.g., a Certified Public Accountant) who, in turn, renders an opinion that indicates the findings of that examination. It adds assurance for investors, creditors, and other users that the information provided by the company is accurate and reliable, and that the information is in accordance with generally accepted accounting principles.
10. CPA means Certified Public Accountant. CMA means Certified Management Accountant. CIA means Certified Internal Auditor. All of these are professional designations that provide assurance of the competence of the individual. In addition, the CPA is a legal license to issue opinions on the fairness of financial statements.
11. The Sarbanes-Oxley Act was passed largely in response to several major financial catastrophes that occurred in 2001 and 2002. It is generally viewed as the most important legislation affecting the accounting profession since the securities acts were passed in the 1930s. It places increased responsibilities on auditors, boards of directors, audit committees, chief executive officers, and chief financial officers of public corporations to take specific steps to insure the integrity of the company's financial reports.
12. The FASB is the primary standard-setting body in the United States that is responsible for establishing generally accepted accounting principles to guide the preparation of financial statements by companies. It works closely with the Securities and Exchange Commission, which is a government body, to develop standards that promote integrity, improve the quality of information reported to external users, and result in financial information that is comparable from one time period to another and from one reporting entity to another.
13. The SEC is a government body that has the legal authority to establish generally accepted accounting principles for publicly held companies. Generally, however, the SEC has permitted the process of establishing GAAP to be carried out in the private sector and has accepted the work of the FASB rather than being directly involved in the process of
14. The primary role of the PCAOB in auditing financial statements is its involvement in establishing auditing standards that are used by the Certified Public Accountants who conduct audits of public companies. The PCAOB also has a number of different roles, including providing oversight of the public accounting profession.
15. The IASB is the organization that creates and promotes International Financial Reporting Standards (IFRS). Its goals are to create a single set of global accounting standards and bring about convergence to those standards. IASB standards are increasingly mandatory throughout the world (e.g., their use is required by companies in the European Union), and are likely to either be allowable or mandatory for U.S. companies within the next few years.

SOLUTIONS TO BRIEF EXERCISES

- B. Ex. 1.1** External users of accounting information include investors, creditors, customers, and regulators.
- B. Ex. 1.2**
- d. Control environment**
 - a. Risk assessment**
 - e. Control activities**
 - c. Information and communication**
 - b. Monitoring**
- B. Ex. 1.3** Accounting relies on inexact or approximate measures because many accounts in financial statements are dependent on judgment about future events and on an assessment of management intent. For example, a business that sells its goods or services on credit must make an estimate of the dollar amount of customer receivables that will ultimately prove uncollectible. The estimation of uncollectible customer receivables involves significant management judgment.
- B. Ex. 1.4** The Securities and Exchange Commission (SEC) has the statutory authority to establish accounting standards for public companies in the United States. The SEC has largely delegated its authority for establishing accounting standards to the Financial Accounting Standards Board (FASB).
- B. Ex. 1.5** The FASB's Conceptual Framework sets forth the Board's views on the: (1) objectives of financial reporting, (2) desired characteristics of accounting information, (3) elements of financial statements, (4) criteria for deciding what information to include in financial statements, and (5) valuation concepts relating to financial statement amounts.
- B. Ex. 1.6** The four primary activities of the PCAOB are: (1) registration, (2) inspections, (3) standard setting, and (4) enforcement.
- B. Ex. 1.7** The sponsoring organizations of COSO are the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA). COSO is best known for developing a framework used in the U.S. for evaluating the effectiveness of an organization's system of internal control.

B. Ex. 1.8 Although there are more than three professional certifications offered in accounting, the three professional certifications that we discuss in this chapter are:

- **Certified Public Accountants (CPA)** -- each state separately licenses CPAs, although the CPA exam is a uniform national exam that is prepared and graded by the AICPA;
- **Certified Management Accountant (CMA)** -- this certification is offered by the Institute of Management Accountants; and
- **Certified Internal Auditor (CIA)** -- this certification is offered by the Institute of Internal Auditors.

B. Ex. 1.9 b. Responsibilities

- e. The Public interest
- f. Integrity
- c. Objectivity and independence
- a. Due care
- d. Scope and nature of services

B. Ex. 1.10 Although there are many potential answers to this question, examples of accounting-related skills useful to many people in their personal lives are: (1) personal budgeting, (2) retirement and college planning, (3) lease vs. buy decisions, (4) evaluating loan terms, and (5) evaluating investment opportunities.

SOLUTIONS TO EXERCISES

Ex. 1.1 The following are just a few of the ways in which you might use accounting information as a student:

- Deciding which school to go to, and what living accommodations you can afford.
- Selecting a major (this involves cost/benefit analysis).
- Estimating your monthly living expenses and planning how to pay them.
- Planning in advance for major expenditures, such as the deposit on an apartment, buying textbooks, paying tuition, or taking a vacation.
- Balancing your checkbook.
- Evaluating employment opportunities—both while you are in school and upon graduation.
- Evaluating how marriage or having a child at this stage of your life might have a financial effect on your goals.

As a student, you may be required to supply financial information about yourself when doing such things as:

- Applying for a credit card.
- Applying for a loan for a car.
- Applying for a scholarship or financial aid.
- Renting an apartment.
- Preparing your personal income tax return.

- Ex. 1.2**
- a. As one of the world's largest pension funds, California Public Employees Retirement System (Cal PERS) also is one of the world's largest stockholders. Cal PERS uses Boeing's financial statements and other financial information to decide whether to include the capital stock of Boeing Company in its investment portfolio.
 - b. As a rapidly growing airline, China Airlines may be a major customer of Boeing for the foreseeable future. Before ordering aircraft (which are ordered years in advance of the delivery dates), China Airlines will want to determine that the manufacturer has the financial capacity to fulfill the contract and also to stand behind its aircraft in years to come. (Aircraft manufacturers, like automakers, sometimes must recall planes to correct defects discovered after years of use.)
 - c. Boeing's financial health and future prospects affect the demand for housing (and apartments) in much of the Seattle area. (*Note to instructor:* Boeing's impact upon Seattle's economy is legendary. However, Seattle's economy has become much more diversified in recent years (for instance, Microsoft, Nordstrom, Starbucks, and Costco are headquartered there), and Boeing has less impact than in the past. Nonetheless, whether Boeing is hiring or laying off workers still is significant—especially in those areas within comfortable commuting distance of Boeing's facilities.)

- d. Management is responsible for planning future operations, using the company's resources efficiently, and generally running the business. These responsibilities require constant use of detailed accounting information about past, current, and expected future operations.
- e. The financial health and future prospects of Boeing affect the contracts that labor unions will be able to negotiate. Boeing's backlog of unfilled orders basically determines who is in the "catbird seat" in labor negotiations—the company or the union.

- Ex. 1.3**
- a. Financial reporting is the process of supplying financial information about an organization to persons outside the organization.
 - b. Financial statements are the principal accounting reports involved in the financial reporting process. The purpose of these statements is to supply persons outside the organization with information about the financial position, profitability, and cash flows of the reporting entity.
 - c. Publicly owned companies are required by law to make their annual and quarterly financial statements public—that is, available to anyone. For other businesses, the decision to distribute financial statements to persons outside the organization may be optional. However, creditors and outside investors generally expect to receive financial statements periodically as a condition of making loans or investments.
 - d. Financial reporting helps decision makers in utilizing scarce economic resources efficiently. These decisions about allocation of resources determine what goods and services become available. Also affected are such aspects of the economy as price levels, employment, research and development, and the standard of living.

Every society—whether its economy is based upon free markets or central planning—benefits when its scarce resources are being utilized efficiently. The efficient use of economic resources means that society gets the maximum benefit out of the resources at its disposal.

- Ex. 1.4**
- a. Generally accepted accounting principles, established by the authoritative standard-setting bodies, are the policies and detailed rules used in determining the content and format of financial statements.
 - b. Accounting principles have evolved from a variety of sources. Today, the primary official sources are the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). However, the American Institute of CPAs (AICPA) and the Securities and Exchange Commission (SEC) also participate in the development of these principles. In addition, accounting principles may gain general acceptance from unofficial sources, such as widespread use.
 - c. The FASB has developed a codification of all promulgated (i.e. written) sources of GAAP. This is as close to a comprehensive list of generally accepted accounting principles as exists. However, GAAP also develops informally through accepted practices. These are not necessarily codified.

- d. Financial statements are the accounting reports that should be prepared in accordance with generally accepted accounting principles. However, the standards of presentation used in income tax returns, reports to regulatory agencies, and various reports to management often make some use of these principles.

Ex. 1.5 a. The FASB (Financial Accounting Standards Board) is the principal authoritative source of new accounting principles and changes in existing accounting principles in the U.S.

- b. Prior to the creation of the FASB, the AICPA (American Institute of Certified Public Accountants) had responsibility for developing accounting principles. Many of the principles developed by the AICPA remain in effect. The AICPA continues to conduct research into accounting issues and to make its findings known to the FASB.
- c. The SEC (Securities and Exchange Commission) has the *legal authority* to specify generally accepted accounting principles. However, the SEC generally has chosen not to develop its own principles, but rather to support those of the FASB. Thus, the SEC gives the force of law to generally accepted accounting principles. The SEC also reviews the financial statements of all publicly owned companies, and investigates possible violations of federal securities laws.

Information about publicly-held companies is most easily obtained from the SEC. Publicly owned corporations must file their quarterly and annual financial statements for review by this agency. The SEC then places this information on EDGAR, a database accessible to the public on the Internet. In contrast, the FASB primarily is a standard-setting organization, and does not accumulate or review financial information about all publicly owned companies. When external users need this type of information, they use EDGAR.

Ex. 1.6 You expect two cash flows from your investment:

Return of investment (at maturity)	\$12,000
Return on investment (periodically, as stated in your investment agreement ($\$12,000 \times 7\% \times 2$ years)	<u>\$1,680</u>
Total expected cash flow	<u><u>\$13,680</u></u>

The return of your investment will come at one time—two years later at the maturity date. The return on the investment can come in different patterns. For example, if it is semi-annually, you would receive \$420 ($\$12,000 \times 7\% \times 1/2$ year) four times. If it is annually, you would receive \$840 ($\$12,000 \times 7\%$) two times. If it is monthly, you would receive \$70 ($\$12,000 \times 7\% \times 1/12$) 24 times.

- Ex. 1.7**
- i. Financial accounting**
 - h. Management accounting**
 - b. Financial reporting**
 - f. Financial statements**
 - g. General-purpose assumption**
 - c. Integrity**
 - e. Internal control**
 - d. Public accounting**
 - a. Bookkeeping**
- Ex. 1.8**
- b. Institute of Internal Auditors**
 - a. Securities and Exchange Commission**
 - g. American Institute of CPAs**
 - c. Institute of Management Accountants**
 - h. Financial Accounting Standards Board**
 - e. American Accounting Association**
 - d. Public Company Accounting Oversight Board**
 - f. International Accounting Standards Board**
- Ex. 1.9**
- a. As an investor in a company, your primary objective would be the return of your investment in the future, as well as a return for the use of your funds used by the company during the period of investment. You would need information that allowed you to assess the probability of those events occurring in the future. You might also have certain nonfinancial objectives.**
 - b. As a manager of the company, your primary objective would be to have information that allows you to better manage the company—to make the best decisions possible to enhance the value of the company.**
 - c. While there is some information that would be equally important for investors and managers, much of the information needed by the two groups is different. That is why we study both financial accounting (information for external users) and managerial accounting (information for internal users).**
- Ex. 1.10**
- a. The primary purposes of management accounting, in hierarchical order (i.e., from general to specific) are as follows:**
 - 1. Information useful to help the enterprise achieve its goals, objectives, and mission.**
 - 2. Information that is useful in assessing both the past performance and future directions of the enterprise and information from external and internal sources.**
 - 3. Information about decision-making authority, for decision-making support, and for evaluating and rewarding decision-making performance.**
 - b. The first is the most general and deals with management's responsibility in the broadest sense—to achieve the enterprise's goals, objectives, and mission. The second is more specific and talks about past performance and future directions. The third is most specific and deals with information for a specific purpose—evaluating and rewarding decision-making performance.**

- c. Examples of the kinds of decisions that are supported by management accounting information are:
- How to more efficiently manage the enterprise's resources.
 - How to reduce the costs of producing a product in order to be more competitive.
 - What supplier can best meet the enterprise's production scheduling.
 - How to better allocate resources internally to achieve the enterprise's objectives.
 - Whether to manufacture a new product.
 - Whether to move into a new geographic area.

- Ex. 1.11
- a. As an accounting educator, the organization that would be most directly involved in activities relevant to your work would be the American Accounting Association. This organization provides members services to permit them to become better at teaching, research, and other activities that are typically associated with an academic career. In addition, many academic accountants are active members of other organizations that are more practice-oriented.
- b. As a management accountant, the Institute of Management Accountants would be the most directly beneficial to you. That organization provides many services directed toward members in industry, including the Certified Management Accountant designation.
- c. As a certified public accountant, the American Institute of Certified Public Accountants would be particularly valuable to you in terms of services that would support your work.

- Ex. 1.12
- a. An audit is an examination of a company's financial statements by an independent third party who has no direct financial interest in the enterprise being audited. The public accountant's role in an audit is to examine the extent to which the financial statements follow generally accepted accounting principles and are presented fairly in accordance with those principles.
- b. As a user of external financial information, the favorable opinion of an external auditor provides you with reasonable assurance that you can rely on those financial statements. This permits you to compare the information of the enterprise with information from previous years or information about other enterprises (assuming they, too, have a favorable audit opinion) in making your investment decisions.
- c. An audit conclusion stating that financial statements are not fairly presented in accordance with generally accepted accounting principles should raise questions about the reliability of the financial information and the desirability of the enterprise as an investment. While there may not be anything wrong with the enterprise, there is certainly a question as to why the statements are not fairly presented. Once the information to explain this is obtained, a conclusion may then be reached as to whether the lack of conformity with generally accepted accounting principles is an important factor in making an investment in the enterprise.

- Ex. 1.13**
- a. An audit is an independent investigation of each item and disclosure contained in a set of financial statements. The purpose of this investigation is to determine that the financial statements provide a fair presentation of the facts in conformity with generally accepted accounting principles.
 - b. An audit is performed by a firm of Certified Public Accountants that is independent of both the company that prepared the financial statements and its management.
 - c. The purpose of an audit is to provide users of financial statements with independent, expert assurance that the financial statements present fairly the financial position of the company, and the results of its operations, in conformity with generally accepted accounting principles. In short, the audit is intended to bridge the credibility gap that might otherwise exist between the reporting entity and the users of the financial statements.

Auditors do not *guarantee* the accuracy of the statements; rather, they offer their expert “opinion” as to the fairness of the statements. The auditor’s opinion is based upon a careful investigation (the *audit*), but there is always the possibility of error. Over many years, however, audited financial statements have accumulated an excellent track record of reliability.

- Ex. 1.14**
- a. People use accounting information to make economic decisions. If the economy is to function efficiently, these decision makers must have *confidence* in the information they are provided, and not think that perhaps the information is being used to deceive them. In large part, decision makers’ confidence in accounting stems from their confidence and trust in the people who *prepare* this information.
 - b. Accountants must rely upon their professional judgment in such matters as determining (1) how to record an unusual transaction that is not discussed in accounting literature, (2) whether or not a specific situation requires disclosure, (3) what information will be most useful to specific decision makers, (4) how an accounting system should be designed to operate most efficiently, (5) the audit procedures necessary in a given situation, (6) what constitutes a “fair” presentation, (7) whether specific actions are ethical and are in keeping with accountants’ responsibilities to serve the public’s interests.

Ex. 1.15 Acosta, who entered public accounting, is likely to find herself specializing in auditing financial statements, in doing income tax work, or in providing management advisory services. With any of these specialties, she will be providing services to a number of different clients. Of course, Acosta may also have followed a path chosen by many other public accountants: she may have left public accounting to pursue a management career in industry. Her background in public accounting will have given her experience that can be useful in many managerial positions.

Nakao, having chosen a managerial career, works for a single company. After gaining some experience, he probably has chosen an area of specialization, such as financial reporting, systems design, cost accounting, financial forecasting, income taxes, or internal auditing. He also may have moved into a management career, such as controller, treasurer, chief financial officer, or chief executive officer.

Martin, who joined a governmental agency, may find herself specializing in management accounting functions similar to those available to Nakao. Or, she may specialize in auditing activities. The government conducts audits to determine the efficiency of governmental operations and those of governmental contractors, and also to determine the fairness of financial information reported to the government. Like Acosta and Nakao, Martin also may have used her accounting background as a stepping-stone to an administrative position.

Mandella, who became an accounting faculty member, probably will specialize in teaching and research. He may direct his efforts toward those topics which he finds of greatest personal interest. Like many other faculty members, Mandella also may engage in management consulting, write textbooks, or spend some time serving within such organizations as the AICPA, the IMA, the IIA, or the AAA.

- Ex. 1.16**
- a. • Consolidated Balance Sheets**
 - Consolidated Statements of Earnings**
 - Consolidated Statements of Stockholders' Equity and Comprehensive Income**
 - Consolidated Statements of Cash Flows**
 - b. • Management's Responsibility for Financial Statements**
 - Management's Report on Internal Control over Financial Reporting**
 - Report of Independent Registered Public Accounting Firm**
 - Notes to Consolidated Financial Statements**
 - 10-Year Summary of Financial and Operating Results**

SOLUTIONS TO CRITICAL THINKING CASES

15 Minutes, Easy

CASE 1.1 FANNIE MAE RELIABILITY OF FINANCIAL STATEMENTS

Several factors prevent a large publicly owned corporation such as Fannie Mae from issuing misleading financial statements, no matter how desperately the company needs investors' capital. To begin with, there is the *basic honesty* and *integrity* of the company's management and its accounting personnel. Many people participate in the preparation of the financial statements of a large corporation. For these statements to be prepared in a grossly misleading manner, all of these people would have to *knowingly participate in an act of criminal fraud*.

Next, there is the audit of Fannie Mae's financial statements by a firm of independent CPAs. These CPAs, too, would have to participate in a criminal conspiracy if the company were to supply creditors and investors with grossly misleading financial statements.

If personal integrity is not sufficient to deter such an act of fraud, the federal securities laws provide for criminal penalties as well as financial liability for all persons engaged in the preparation and distribution of fraudulent financial statements. All that would be necessary for the SEC to launch an investigation would be a "tip" from but one individual within the company's organization or its auditing firm. An investigation also would be launched automatically if the company declared bankruptcy or became insolvent shortly after issuing financial statements that did not indicate a shaky financial position.

OBJECTIVES OF FINANCIAL ACCOUNTING

- a. Describing financial accounting as being useful for decision making by investors or creditors and as the language of business are very consistent. For information to be used by decision makers—whether internal or external—that information must be communicated. The process of communicating the information is why accounting is sometimes referred to as the language of business.

Communication involves a sender and a receiver. The message between the two is communicated in some manner, which could be words, numbers, or in some other way. While communicating accounting information usually involves numbers that are stated in terms of a monetary unit (e.g., dollars), such information also requires words for the monetary information to be meaningful.

- b. As an external investor or creditor, your primary concern is the security of your investment and the return you are making on permitting another to use your money rather than your having use of it yourself. As an internal manager, on the other hand, you are primarily interested in operating the business and you need information that helps you make the kinds of decisions that are required by the particular business you are in. Some information is equally useful for external investors and internal managers; other information is unique to each group of users of accounting information.

CASE 1.3

ACCOUNTING SYSTEMS

- a. **An accounting system is everything that it takes to produce reliable and accurate accounting information—people, equipment, computers, software, technical knowledge, etc.**
- b. **The purpose of an accounting system is to provide information needed by the organization, and to do this in an efficient manner. The basic functions of an accounting system are to:**
 - **Interpret and record business transactions.**
 - **Classify information in a way that is useful for investors, creditors, management, and other information users.**
 - **Summarize and communicate information to decision makers.**
- c. **The design and implementation of an accounting system varies from situation to situation, but it always involves people with specialized knowledge of financial and managerial accounting and increasingly incorporates computer technology.**

CASE 1.4

CODES OF ETHICS

ETHICS, FRAUD & CORPORATE GOVERNANCE

Among the things you would learn in studying the Statement of Ethical Professional Practice of the IMA is that the code includes requirements in the following areas: competence, confidentiality, integrity, and credibility. While these may sound like “lofty” terms, they will have direct relevance to you in your job, starting on the very first day.

Competence refers to the quality of having the skills, knowledge, and background to be able to do a quality job on the work you are assigned. Your new employer has undoubtedly already made a judgment about your competence, and you passed the test, or you would not have been hired.

Confidentiality refers to the fact that some of the information you will deal with may be sensitive in terms of who should have access to it. Your responsibility includes taking care to not misuse information in any way.

Integrity refers to your need to avoid conflicts of interest by doing something that would subvert your organization’s objectives, communicate biased information, or engage in activities that would discredit your company or the accounting profession.

Credibility means that you should communicate information in a fair and unbiased manner, and that you should include all information that is required for understanding that information.

CASE 1.5

ACCESSING INFORMATION ON THE INTERNET

INTERNET

- a. Deloitte's service lines are: audit and enterprise risk services, consulting, financial advisory services, and tax. Ernst & Young's service lines are advisory, assurance, tax, and transactions. KPMG's service lines are: audit, tax, and advisory. PricewaterhouseCoopers
- b. The PCAOB's four major activities are: registration and reporting, standards, inspections,
- c. At the time this book went to press, the five members of the FASB were: Robert Herz, Thomas Linsmeier, Leslie Seidman, Marc Siegel, Lawrence Smith. Herz is the FASB's chairman and prior to joining the FASB he was a senior technical partner at PricewaterhouseCoopers. Linsmeier was formerly a professor at Michigan State University. Seidman was formerly vice president of accounting policy at J.P. Morgan. Siegel formerly led the accounting research and analysis team at Risk Metrics. Smith formerly served as a senior FASB staff member.
- d. At the time this book went to press, the IASB had 15 board members: Sir David Tweedie, Stephen Cooper, Philippe Danjou, Jan Engstrom, Patrick Finnegan, Amaro Luiz de Oliveira Gomes, Prabhakar Kalavacharia, Dr. Elke Konig, Patricia McConnell, Warren McGregor, Paul Pacter, Darrel Scott, John Smith, Tatsumi Yamada, and Zhang Wei-Guo. Biographical sketches of these 15 individuals are available on the IASB's web site.

CHAPTER 1

ACCOUNTING: INFORMATION FOR DECISION MAKING

OVERVIEW OF BRIEF EXERCISES, EXERCISES, AND CRITICAL THINKING CASES

Brief Exercises	Topic	Learning Objectives	Skills
B. Ex. 1.1	Users of accounting information	1, 3, 5	Analysis
B. Ex. 1.2	Components of internal control	2, 5	Analysis
B. Ex. 1.3	Inexact or approximate measures	3, 4	Analysis, judgment
B. Ex. 1.4	Standards for the preparation of accounting information	5, 6	Analysis
B. Ex. 1.5	FASB conceptual framework	1, 3, 5, 6	Analysis
B. Ex. 1.6	PCAOB	5, 6	Analysis, research
B. Ex. 1.7	COSO	2, 5, 6	Analysis, ethics
B. Ex. 1.8	Professional certifications in accounting	7, 8	Analysis
B. Ex. 1.9	AICPA code of professional conduct	5, 7	Analysis, ethics
B. Ex. 1.10	Personal benefits of accounting skills	1	Analysis

Exercises	Topic	Learning Objectives	Skills
1.1	You as a user of accounting information	1	Analysis, judgment
1.2	Real World: Boeing Company, California Public Employees Retirement System, China Airlines Users of accounting information	3, 4	Analysis, research
1.3	What is financial reporting?	3	Analysis, judgment
1.4	Generally accepted accounting principles	6	Analysis
1.5	Accounting organizations	6	Analysis, communication
1.6	Investment return	3	Analysis
1.7	Accounting terminology	3-5, 7	Analysis
1.8	Accounting organizations	6	Analysis
1.9	Financial and management accounting	3, 4	Judgment
1.10	Management accounting information	4	Communication, judgment
1.11	Accounting organizations	6	Analysis, judgment
1.12	Purpose of an audit	5	Analysis, judgment
1.13	Audits of financial statements	5	Analysis
1.14	Ethics and professional judgment	7	Analysis, communication, judgment
1.15	Careers in accounting	8	Judgment, communication
1.16	Home Depot, Inc. general information	1, 3, 5	Analysis, judgment, research

Due to the introductory nature of this chapter and the conceptual nature of its contents, no items labeled **Problems** are included. In all future chapters you will find a series of Problems that generally include computations, are more complex, and generally require more time to complete than Exercises.

Critical Thinking Cases

1.1	Real World: Fannie Mae Reliability of financial statements	5	Analysis, ethics,
1.2	Objectives of financial accounting	3	Analysis, communication, group, judgment
1.3	Accounting systems	2	Analysis, communication
1.4	Codes of ethics (Ethics, fraud, and corporate governance)	7	Analysis, communication, judgment
1.5	Accessing information on the Internet (Internet)	6, 7	Research, technology

DESCRIPTIONS OF CRITICAL THINKING CASES

Below are brief descriptions of each case. These descriptions are accompanied by the estimated time (in minutes) required for completion and by a difficulty rating.

Critical Thinking Cases

- | | | |
|------------|--|------------------|
| 1.1 | Fannie Mae
Reliability of Financial Statements
This case explores the general subject of integrity in financial statements—what causes potential investors to be able to rely on information and what precludes management from portraying a company in more positive terms than it should. | 15 Easy |
| 1.2 | Objectives of Financial Accounting
Characteristics of accounting and accounting information (e.g., useful for decision making, language of business) are used to explain the importance of accounting information. | 15 Medium |
| 1.3 | Accounting Systems
The purpose and functions of accounting systems are covered, as well as the definition of what an accounting system is and who is responsible for designing and implementing accounting systems. | 15 Easy |
| 1.4 | Codes of Ethics
Ethics, Fraud, and Corporate Governance
Students are placed in the position of a new employee who is faced with the challenge of becoming familiar with an appropriate code of ethics and must think through how that code might influence his/her behavior on the job. | 30 Medium |
| 1.5 | Accessing Information on the Internet
Internet
Students are introduced to learning on the Internet by accessing the Rutgers University web page on accounting information. Once there, they learn about accounting firms, accounting textbook publishers, and professional accounting organizations. | 30 Medium |

SUGGESTED ANSWERS TO DISCUSSION QUESTIONS

Note to instructor: We regularly include discussion questions as part of the assigned homework. One objective of these questions is to help students develop communications skills; however, we find that they also increase students' conceptual understanding of accounting.

1. Accounting is a way of communicating the results of business activity and, therefore, is sometimes described as the language of business. Among the important accounting measurements that communicate business activity and justify describing accounting as the language of business are costs, prices, sales volume, profits, and return on investment.
2. The return of your investment is the repayment to you of the amount you invested earlier. The return on your investment is what the company pays you for having the use of your money while it was invested as opposed to your having use of the money while it was invested.
3. The three primary objectives of financial reporting, from general to specific, are to provide:
 - Information that is useful in making investment and credit decisions.
 - Information useful in assessing the amount, timing, and uncertainty of future cash flows.
 - Information about economic resources, claims to resources, and changes in resources and claims on them.
4. The three primary financial statements that are the means of communicating financial accounting information are:
 - Statement of financial position (balance sheet)—A statement that shows where the company stands at a point in time.
 - Income statement—A statement that details the results of the company's profit-seeking activities during a period of time.
 - Statement of cash flows—A statement that presents details of the company's cash balance—how it increased, how it decreased, and how the ending balance compares with the beginning balance—for a period of time.
5. While financial information has an appearance of precision, it often requires judgment and estimation and, thus, is less precise than one might think. For example, to determine certain information about a company for a certain year, or at a certain point in time, it may be necessary to make estimates about the future. Those estimates may or may not turn out, in the long term, to be precisely correct. This causes information about the current year to be less precise and accurate than would otherwise be the case.
6. Internal accounting information is primarily oriented toward the future. While some management accounting information is historical, the purpose of management accounting information is to facilitate current and future decision making that is in the best interests of the company and that is consistent with the company's mission. Financial accounting information, while also used for current and future decision making, is generally more historical in nature than is management accounting. Financial accounting information deals primarily with the financial activities of the enterprise during recent past periods.
7. Generally accepted accounting principles are agreed-upon ways that economic activity will be captured and reported in monetary terms. They are important in insuring the integrity of financial accounting information and being able to compare the information of one enterprise with that of another enterprise.

8. *Internal control* is a process designed to provide reasonable assurance that the organization produces reliable financial reports, complies with applicable laws and regulations, and conducts operations in an efficient and effective manner. The five components of internal control per the COSO framework are the control environment, risk assessment, control activities, information and communication, and monitoring.
9. An audit is an examination of a company's financial information, including financial statements, by an independent expert (e.g., a Certified Public Accountant) who, in turn, renders an opinion that indicates the findings of that examination. It adds assurance for investors, creditors, and other users that the information provided by the company is accurate and reliable, and that the information is in accordance with generally accepted accounting principles.
10. CPA means Certified Public Accountant. CMA means Certified Management Accountant. CIA means Certified Internal Auditor. All of these are professional designations that provide assurance of the competence of the individual. In addition, the CPA is a legal license to issue opinions on the fairness of financial statements.
11. The Sarbanes-Oxley Act was passed largely in response to several major financial catastrophes that occurred in 2001 and 2002. It is generally viewed as the most important legislation affecting the accounting profession since the securities acts were passed in the 1930s. It places increased responsibilities on auditors, boards of directors, audit committees, chief executive officers, and chief financial officers of public corporations to take specific steps to insure the integrity of the company's financial reports.
12. The FASB is the primary standard-setting body in the United States that is responsible for establishing generally accepted accounting principles to guide the preparation of financial statements by companies. It works closely with the Securities and Exchange Commission, which is a government body, to develop standards that promote integrity, improve the quality of information reported to external users, and result in financial information that is comparable from one time period to another and from one reporting entity to another.
13. The SEC is a government body that has the legal authority to establish generally accepted accounting principles for publicly held companies. Generally, however, the SEC has permitted the process of establishing GAAP to be carried out in the private sector and has accepted the work of the FASB rather than being directly involved in the process of establishing standards.
14. The primary role of the PCAOB in auditing financial statements is its involvement in establishing auditing standards that are used by the Certified Public Accountants who conduct audits of public companies. The PCAOB also has a number of different roles, including providing oversight of the public accounting profession.
15. The IASB is the organization that creates and promotes International Financial Reporting Standards (IFRS). Its goals are to create a single set of global accounting standards and bring about convergence to those standards. IASB standards are increasingly mandatory throughout the world (e.g., their use is required by companies in the European Union), and are likely to either be allowable or mandatory for U.S. companies within the next few years.

SOLUTIONS TO BRIEF EXERCISES

- B. Ex. 1.1** External users of accounting information include investors, creditors, customers, and regulators.
- B. Ex. 1.2**
- d. Control environment**
 - a. Risk assessment**
 - e. Control activities**
 - c. Information and communication**
 - b. Monitoring**
- B. Ex. 1.3** Accounting relies on inexact or approximate measures because many accounts in financial statements are dependent on judgment about future events and on an assessment of management intent. For example, a business that sells its goods or services on credit must make an estimate of the dollar amount of customer receivables that will ultimately prove uncollectible. The estimation of uncollectible customer receivables involves significant management judgment.
- B. Ex. 1.4** The Securities and Exchange Commission (SEC) has the statutory authority to establish accounting standards for public companies in the United States. The SEC has largely delegated its authority for establishing accounting standards to the Financial Accounting Standards Board (FASB).
- B. Ex. 1.5** The FASB's Conceptual Framework sets forth the Board's views on the: (1) objectives of financial reporting, (2) desired characteristics of accounting information, (3) elements of financial statements, (4) criteria for deciding what information to include in financial statements, and (5) valuation concepts relating to financial statement amounts.
- B. Ex. 1.6** The four primary activities of the PCAOB are: (1) registration, (2) inspections, (3) standard setting, and (4) enforcement.
- B. Ex. 1.7** The sponsoring organizations of COSO are the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA). COSO is best known for developing a framework used in the U.S. for evaluating the effectiveness of an organization's system of internal control.

- B. Ex. 1.8** Although there are more than three professional certifications offered in accounting, the three professional certifications that we discuss in this chapter are:
- **Certified Public Accountants (CPA)** -- each state separately licenses CPAs, although the CPA exam is a uniform national exam that is prepared and graded by the AICPA;
 - **Certified Management Accountant (CMA)** -- this certification is offered by the Institute of Management Accountants; and
 - **Certified Internal Auditor (CIA)** -- this certification is offered by the Institute of Internal Auditors.

- B. Ex. 1.9**
- b. Responsibilities**
 - e. The Public interest**
 - f. Integrity**
 - c. Objectivity and independence**
 - a. Due care**
 - d. Scope and nature of services**

- B. Ex. 1.10** Although there are many potential answers to this question, examples of accounting-related skills useful to many people in their personal lives are: (1) personal budgeting, (2) retirement and college planning, (3) lease vs. buy decisions, (4) evaluating loan terms, and (5) evaluating investment opportunities.

SOLUTIONS TO EXERCISES

Ex. 1.1 The following are just a few of the ways in which you might use accounting information as a student:

- Deciding which school to go to, and what living accommodations you can afford.
- Selecting a major (this involves cost/benefit analysis).
- Estimating your monthly living expenses and planning how to pay them.
- Planning in advance for major expenditures, such as the deposit on an apartment, buying textbooks, paying tuition, or taking a vacation.
- Balancing your checkbook.
- Evaluating employment opportunities—both while you are in school and upon graduation.
- Evaluating how marriage or having a child at this stage of your life might have a financial effect on your goals.

As a student, you may be required to supply financial information about yourself when doing such things as:

- Applying for a credit card.
- Applying for a loan for a car.
- Applying for a scholarship or financial aid.
- Renting an apartment.
- Preparing your personal income tax return.

- Ex. 1.2**
- a. As one of the world's largest pension funds, California Public Employees Retirement System (Cal PERS) also is one of the world's largest stockholders. Cal PERS uses Boeing's financial statements and other financial information to decide whether to include the capital stock of Boeing Company in its investment portfolio.
 - b. As a rapidly growing airline, China Airlines may be a major customer of Boeing for the foreseeable future. Before ordering aircraft (which are ordered years in advance of the delivery dates), China Airlines will want to determine that the manufacturer has the financial capacity to fulfill the contract and also to stand behind its aircraft in years to come. (Aircraft manufacturers, like automakers, sometimes must recall planes to correct defects discovered after years of use.)
 - c. Boeing's financial health and future prospects affect the demand for housing (and apartments) in much of the Seattle area. (*Note to instructor:* Boeing's impact upon Seattle's economy is legendary. However, Seattle's economy has become much more diversified in recent years (for instance, Microsoft, Nordstrom, Starbucks, and Costco are headquartered there), and Boeing has less impact than in the past. Nonetheless, whether Boeing is hiring or laying off workers still is significant—especially in those areas within commuting

workers still is significant—especially in those areas within comfortable commuting distance of Boeing’s facilities.)

- d. Management is responsible for planning future operations, using the company's resources efficiently, and generally running the business. These responsibilities require constant use of detailed accounting information about past, current, and expected future operations.
- e. The financial health and future prospects of Boeing affect the contracts that labor unions will be able to negotiate. Boeing's backlog of unfilled orders basically determines who is in the "catbird seat" in labor negotiations—the company or the union.

- Ex. 1.3**
- a. Financial reporting is the process of supplying financial information about an organization to persons outside the organization.
 - b. Financial statements are the principal accounting reports involved in the financial reporting process. The purpose of these statements is to supply persons outside the organization with information about the financial position, profitability, and cash flows of the reporting entity.
 - c. Publicly owned companies are required by law to make their annual and quarterly financial statements public—that is, available to anyone. For other businesses, the decision to distribute financial statements to persons outside the organization may be optional. However, creditors and outside investors generally expect to receive financial statements periodically as a condition of making loans or investments.
 - d. Financial reporting helps decision makers in utilizing scarce economic resources efficiently. These decisions about allocation of resources determine what goods and services become available. Also affected are such aspects of the economy as price levels, employment, research and development, and the standard of living.

Every society—whether its economy is based upon free markets or central planning—benefits when its scarce resources are being utilized efficiently. The efficient use of economic resources means that society gets the maximum benefit out of the resources at its disposal.

- Ex. 1.4**
- a. Generally accepted accounting principles, established by the authoritative standard-setting bodies, are the policies and detailed rules used in determining the content and format of financial statements.
 - b. Accounting principles have evolved from a variety of sources. Today, the primary official sources are the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). However, the American Institute of CPAs (AICPA) and the Securities and Exchange Commission (SEC) also participate in the development of these principles. In addition, accounting principles may gain general acceptance from unofficial sources, such as widespread use.
 - c. The FASB has developed a codification of all promulgated (i.e. written) sources of GAAP. This is as close to a comprehensive list of generally accepted accounting principles as exists. However, GAAP also develops informally through accepted practices. These are not necessarily codified.

- d. Financial statements are the accounting reports that should be prepared in accordance with generally accepted accounting principles. However, the standards of presentation used in income tax returns, reports to regulatory agencies, and various reports to management often make some use of these principles.

- Ex. 1.5
- a. The FASB (Financial Accounting Standards Board) is the principal authoritative source of new accounting principles and changes in existing accounting principles in the U.S.
 - b. Prior to the creation of the FASB, the AICPA (American Institute of Certified Public Accountants) had responsibility for developing accounting principles. Many of the principles developed by the AICPA remain in effect. The AICPA continues to conduct research into accounting issues and to make its findings known to the FASB.
 - c. The SEC (Securities and Exchange Commission) has the *legal authority* to specify generally accepted accounting principles. However, the SEC generally has chosen not to develop its own principles, but rather to support those of the FASB. Thus, the SEC gives the force of law to generally accepted accounting principles. The SEC also reviews the financial statements of all publicly owned companies, and investigates possible violations of federal securities laws.

Information about publicly-held companies is most easily obtained from the SEC. Publicly owned corporations must file their quarterly and annual financial statements for review by this agency. The SEC then places this information on EDGAR, a database accessible to the public on the Internet. In contrast, the FASB primarily is a standard-setting organization, and does not accumulate or review financial information about all publicly owned companies. When external users need this type of information, they use EDGAR.

- Ex. 1.6 You expect two cash flows from your investment:

Return of investment (at maturity)	\$12,000
Return on investment (periodically, as stated in your investment agreement ($\$12,000 \times 7\% \times 2$ years)	<u>\$1,680</u>
Total expected cash flow	<u><u>\$13,680</u></u>

The return of your investment will come at one time—two years later at the maturity date. The return on the investment can come in different patterns. For example, if it is semi-annually, you would receive \$420 ($\$12,000 \times 7\% \times 1/2$ year) four times. If it is annually, you would receive \$840 ($\$12,000 \times 7\%$) two times. If it is monthly, you would receive \$70 ($\$12,000 \times 7\% \times 1/12$) 24 times.

- Ex. 1.7**
- i. Financial accounting**
 - h. Management accounting**
 - b. Financial reporting**
 - f. Financial statements**
 - g. General-purpose assumption**
 - c. Integrity**
 - e. Internal control**
 - d. Public accounting**
 - a. Bookkeeping**
- Ex. 1.8**
- b. Institute of Internal Auditors**
 - a. Securities and Exchange Commission**
 - g. American Institute of CPAs**
 - c. Institute of Management Accountants**
 - h. Financial Accounting Standards Board**
 - e. American Accounting Association**
 - d. Public Company Accounting Oversight Board**
 - f. International Accounting Standards Board**
- Ex. 1.9**
- a. As an investor in a company, your primary objective would be the return of your investment in the future, as well as a return for the use of your funds used by the company during the period of investment. You would need information that allowed you to assess the probability of those events occurring in the future. You might also have certain nonfinancial objectives.**
 - b. As a manager of the company, your primary objective would be to have information that allows you to better manage the company—to make the best decisions possible to enhance the value of the company.**
 - c. While there is some information that would be equally important for investors and managers, much of the information needed by the two groups is different. That is why we study both financial accounting (information for external users) and managerial accounting (information for internal users).**
- Ex. 1.10**
- a. The primary purposes of management accounting, in hierarchical order (i.e., from general to specific) are as follows:**
 - 1. Information useful to help the enterprise achieve its goals, objectives, and mission.**
 - 2. Information that is useful in assessing both the past performance and future directions of the enterprise and information from external and internal sources.**
 - 3. Information about decision-making authority, for decision-making support, and for evaluating and rewarding decision-making performance.**
 - b. The first is the most general and deals with management's responsibility in the broadest sense—to achieve the enterprise's goals, objectives, and mission. The second is more specific and talks about past performance and future directions. The third is most specific and deals with information for a specific purpose—evaluating and rewarding decision-making performance.**

- c. Examples of the kinds of decisions that are supported by management accounting information are:
- How to more efficiently manage the enterprise's resources.
 - How to reduce the costs of producing a product in order to be more competitive.
 - What supplier can best meet the enterprise's production scheduling.
 - How to better allocate resources internally to achieve the enterprise's objectives.
 - Whether to manufacture a new product.
 - Whether to move into a new geographic area.

- Ex. 1.11**
- a. As an accounting educator, the organization that would be most directly involved in activities relevant to your work would be the American Accounting Association. This organization provides members services to permit them to become better at teaching, research, and other activities that are typically associated with an academic career. In addition, many academic accountants are active members of other organizations that are more practice-oriented.
- b. As a management accountant, the Institute of Management Accountants would be the most directly beneficial to you. That organization provides many services directed toward members in industry, including the Certified Management Accountant designation.
- c. As a certified public accountant, the American Institute of Certified Public Accountants would be particularly valuable to you in terms of services that would support your work.

- Ex. 1.12**
- a. An audit is an examination of a company's financial statements by an independent third party who has no direct financial interest in the enterprise being audited. The public accountant's role in an audit is to examine the extent to which the financial statements follow generally accepted accounting principles and are presented fairly in accordance with those principles.
- b. As a user of external financial information, the favorable opinion of an external auditor provides you with reasonable assurance that you can rely on those financial statements. This permits you to compare the information of the enterprise with information from previous years or information about other enterprises (assuming they, too, have a favorable audit opinion) in making your investment decisions.
- c. An audit conclusion stating that financial statements are not fairly presented in accordance with generally accepted accounting principles should raise questions about the reliability of the financial information and the desirability of the enterprise as an investment. While there may not be anything wrong with the enterprise, there is certainly a question as to why the statements are not fairly presented. Once the information to explain this is obtained, a conclusion may then be reached as to whether the lack of conformity with generally accepted accounting principles is an important factor in making an investment in the enterprise.

- Ex. 1.13**
- a. An audit is an independent investigation of each item and disclosure contained in a set of financial statements. The purpose of this investigation is to determine that the financial statements provide a fair presentation of the facts in conformity with generally accepted accounting principles.**
 - b. An audit is performed by a firm of Certified Public Accountants that is independent of both the company that prepared the financial statements and its management.**
 - c. The purpose of an audit is to provide users of financial statements with independent, expert assurance that the financial statements present fairly the financial position of the company, and the results of its operations, in conformity with generally accepted accounting principles. In short, the audit is intended to bridge the credibility gap that might otherwise exist between the reporting entity and the users of the financial statements.**

Auditors do not *guarantee* the accuracy of the statements; rather, they offer their expert “opinion” as to the fairness of the statements. The auditor’s opinion is based upon a careful investigation (the *audit*), but there is always the possibility of error. Over many years, however, audited financial statements have accumulated an excellent track record of reliability.

- Ex. 1.14**
- a. People use accounting information to make economic decisions. If the economy is to function efficiently, these decision makers must have *confidence* in the information they are provided, and not think that perhaps the information is being used to deceive them. In large part, decision makers’ confidence in accounting stems from their confidence and trust in the people who *prepare* this information.**
 - b. Accountants must rely upon their professional judgment in such matters as determining (1) how to record an unusual transaction that is not discussed in accounting literature, (2) whether or not a specific situation requires disclosure, (3) what information will be most useful to specific decision makers, (4) how an accounting system should be designed to operate most efficiently, (5) the audit procedures necessary in a given situation, (6) what constitutes a “fair” presentation, (7) whether specific actions are ethical and are in keeping with accountants’ responsibilities to serve the public’s interests.**

Ex. 1.15 Acosta, who entered public accounting, is likely to find herself specializing in auditing financial statements, in doing income tax work, or in providing management advisory services. With any of these specialties, she will be providing services to a number of different clients. Of course, Acosta may also have followed a path chosen by many other public accountants: she may have left public accounting to pursue a management career in industry. Her background in public accounting will have given her experience that can be useful in many managerial positions.

Nakao, having chosen a managerial career, works for a single company. After gaining some experience, he probably has chosen an area of specialization, such as financial reporting, systems design, cost accounting, financial forecasting, income taxes, or internal auditing. He also may have moved into a management career, such as controller, treasurer, chief financial officer, or chief executive officer.

Martin, who joined a governmental agency, may find herself specializing in management accounting functions similar to those available to Nakao. Or, she may specialize in auditing activities. The government conducts audits to determine the efficiency of governmental operations and those of governmental contractors, and also to determine the fairness of financial information reported to the government. Like Acosta and Nakao, Martin also may have used her accounting background as a stepping-stone to an administrative position.

Mandella, who became an accounting faculty member, probably will specialize in teaching and research. He may direct his efforts toward those topics which he finds of greatest personal interest. Like many other faculty members, Mandella also may engage in management consulting, write textbooks, or spend some time serving within such organizations as the AICPA, the IMA, the IIA, or the AAA.

- Ex. 1.16**
- a. • Consolidated Balance Sheets**
 - Consolidated Statements of Earnings**
 - Consolidated Statements of Stockholders' Equity and Comprehensive Income**
 - Consolidated Statements of Cash Flows**
 - b. • Management's Responsibility for Financial Statements**
 - Management's Report on Internal Control over Financial Reporting**
 - Report of Independent Registered Public Accounting Firm**
 - Notes to Consolidated Financial Statements**
 - 10-Year Summary of Financial and Operating Results**

SOLUTIONS TO CRITICAL THINKING CASES

15 Minutes, Easy

CASE 1.1 FANNIE MAE RELIABILITY OF FINANCIAL STATEMENTS

Several factors prevent a large publicly owned corporation such as Fannie Mae from issuing misleading financial statements, no matter how desperately the company needs investors' capital. To begin with, there is the *basic honesty* and *integrity* of the company's management and its accounting personnel. Many people participate in the preparation of the financial statements of a large corporation. For these statements to be prepared in a grossly misleading manner, all of these people would have to *knowingly participate in an act of criminal fraud*.

Next, there is the audit of Fannie Mae's financial statements by a firm of independent CPAs. These CPAs, too, would have to participate in a criminal conspiracy if the company were to supply creditors and investors with grossly misleading financial statements.

If personal integrity is not sufficient to deter such an act of fraud, the federal securities laws provide for criminal penalties as well as financial liability for all persons engaged in the preparation and distribution of fraudulent financial statements. All that would be necessary for the SEC to launch an investigation would be a "tip" from but one individual within the company's organization or its auditing firm. An investigation also would be launched automatically if the company declared bankruptcy or became insolvent shortly after issuing financial statements that did not indicate a shaky financial position.

CASE 1.2

OBJECTIVES OF FINANCIAL ACCOUNTING

- a. Describing financial accounting as being useful for decision making by investors or creditors and as the language of business are very consistent. For information to be used by decision makers—whether internal or external—that information must be communicated. The process of communicating the information is why accounting is sometimes referred to as the language of business.

Communication involves a sender and a receiver. The message between the two is communicated in some manner, which could be words, numbers, or in some other way. While communicating accounting information usually involves numbers that are stated in terms of a monetary unit (e.g., dollars), such information also requires words for the monetary information to be meaningful.

- b. As an external investor or creditor, your primary concern is the security of your investment and the return you are making on permitting another to use your money rather than your having use of it yourself. As an internal manager, on the other hand, you are primarily interested in operating the business and you need information that helps you make the kinds of decisions that are required by the particular business you are in. Some information is equally useful for external investors and internal managers; other information is unique to each group of users of accounting information.

CASE 1.3

ACCOUNTING SYSTEMS

- a. **An accounting system is everything that it takes to produce reliable and accurate accounting information—people, equipment, computers, software, technical knowledge, etc.**
- b. **The purpose of an accounting system is to provide information needed by the organization, and to do this in an efficient manner. The basic functions of an accounting system are to:**
 - **Interpret and record business transactions.**
 - **Classify information in a way that is useful for investors, creditors, management, and other information users.**
 - **Summarize and communicate information to decision makers.**
- c. **The design and implementation of an accounting system varies from situation to situation, but it always involves people with specialized knowledge of financial and managerial accounting and increasingly incorporates computer technology.**

CASE 1.4

CODES OF ETHICS

ETHICS, FRAUD & CORPORATE GOVERNANCE

Among the things you would learn in studying the Statement of Ethical Professional Practice of the IMA is that the code includes requirements in the following areas: competence, confidentiality, integrity, and credibility. While these may sound like “lofty” terms, they will have direct relevance to you in your job, starting on the very first day.

Competence refers to the quality of having the skills, knowledge, and background to be able to do a quality job on the work you are assigned. Your new employer has undoubtedly already made a judgment about your competence, and you passed the test, or you would not have been hired.

Confidentiality refers to the fact that some of the information you will deal with may be sensitive in terms of who should have access to it. Your responsibility includes taking care to not misuse information in any way.

Integrity refers to your need to avoid conflicts of interest by doing something that would subvert your organization’s objectives, communicate biased information, or engage in activities that would discredit your company or the accounting profession.

Credibility means that you should communicate information in a fair and unbiased manner, and that you should include all information that is required for understanding that information.

30 Minutes, Medium

CASE 1.5

ACCESSING INFORMATION ON THE INTERNET INTERNET

- a. Deloitte's service lines are: audit and enterprise risk services, consulting, financial advisory services, and tax. Ernst & Young's service lines are advisory, assurance, tax, and transactions. KPMG's service lines are: audit, tax, and advisory. PricewaterhouseCoopers
- b. The PCAOB's four major activities are: registration and reporting, standards, inspections,
- c. At the time this book went to press, the five members of the FASB were: Robert Herz, Thomas Linsmeier, Leslie Seidman, Marc Siegel, Lawrence Smith. Herz is the FASB's chairman and prior to joining the FASB he was a senior technical partner at PricewaterhouseCoopers. Linsmeier was formerly a professor at Michigan State University. Seidman was formerly vice president of accounting policy at J.P. Morgan. Siegel formerly led the accounting research and analysis team at Risk Metrics. Smith formerly served as a senior FASB staff member.
- d. At the time this book went to press, the IASB had 15 board members: Sir David Tweedie, Stephen Cooper, Philippe Danjou, Jan Engstrom, Patrick Finnegan, Amaro Luiz de Oliveira Gomes, Prabhakar Kalavacheria, Dr. Elke Konig, Patricia McConnell, Warren McGregor, Paul Pacter, Darrel Scott, John Smith, Tatsumi Yamada, and Zhang Wei-Guo. Biographical sketches of these 15 individuals are available on the IASB's web site.