The Role of Accounting in Business

Chapter 1
Learning Objectives

After studying this chapter, you should be able to:

• Describe the types and forms of businesses, how businesses make money, and business stakeholders

• Describe the three business activities of financing, investing, and operating.

• Define accounting and describe its role in business.

• Describe and illustrate the basic financial statements and how they interrelate.

• Describe eight accounting concepts underlying financial reporting.
Learning Objective 1

Describe the types and forms of businesses, how businesses make money, and business stakeholders
Types of Businesses

Service Business  Manufacturing Business  Merchandising Business

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Forms of Business

Considerations in choosing a form of business:
Differences in Forms of Business Organization

<table>
<thead>
<tr>
<th>Form</th>
<th>Ease</th>
<th>Legal Liability</th>
<th>Taxation</th>
<th>Limited Life</th>
<th>Capital Access</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Simple</td>
<td></td>
<td></td>
<td>Yes</td>
<td>Limited</td>
</tr>
<tr>
<td></td>
<td>Simple</td>
<td></td>
<td></td>
<td>Yes</td>
<td>Average</td>
</tr>
<tr>
<td></td>
<td>Complex</td>
<td></td>
<td></td>
<td>No</td>
<td>Extensive</td>
</tr>
<tr>
<td></td>
<td>Moderate</td>
<td></td>
<td></td>
<td>Yes</td>
<td>Average</td>
</tr>
</tbody>
</table>
How Do Businesses Make Money?

By providing goods and services to customers so that they can make a ___________. To maximize their profits, companies may use one of the following two strategies:

- **Premium Price Strategy**
- **Low Cost Strategy**

**Exhibit 1: Business Strategies and Industries**

<table>
<thead>
<tr>
<th>Business Strategy</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium price</td>
<td>Freight: FedEx, Automotive: BMW, Retail: Talbot's, Financial Services: Morgan Stanley, Hotel: Ritz-Carlton</td>
</tr>
</tbody>
</table>

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# Business Stakeholders

## Exhibit 2: Business Stakeholders

<table>
<thead>
<tr>
<th>Business Stakeholder</th>
<th>Interest in the Business</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital market stakeholders</td>
<td>Providers of major financing for the business</td>
<td>Banks, owners, stockholders</td>
</tr>
<tr>
<td>Product or service market stakeholders</td>
<td>Buyers of products or services and vendors to the business</td>
<td>Customers and suppliers</td>
</tr>
<tr>
<td>Government stakeholders</td>
<td>Collect taxes and fees from the business and its employees</td>
<td>Federal, state, and city governments</td>
</tr>
<tr>
<td>Internal stakeholders</td>
<td>Individuals employed by the business</td>
<td>Employees and managers</td>
</tr>
</tbody>
</table>
Learning Objective 2

Describe the three business activities of financing, investing, and operating.
Exhibit 4: Business Activities

Business Activities

- Financing Activities
  - Banks and/or Owners
- Operating Activities
  - Customers and Suppliers
- Investing Activities
  - Purchasing
Learning Objective 3

Define accounting and describe its role in business
Objectives of Financial Accounting

Sometimes called the “________________________”, Accounting is an information system that provides reports to stakeholders about the economic activities and condition of a business.

Essentially, it summarizes the financial performance of the firm for external users.
Two Major Objectives of Financial Accounting

Exhibit 5: Objectives of Financial Accounting

Financial Condition As of a __________
__________________________

Financial Condition at January 1, 2012

Change in Financial Condition for Year Ending
December 31, 2012

Financial Condition at December 31, 2012

Financial Condition Over a __________
__________________________

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Learning Objective 4

Describe and illustrate the basic financial statements and how they interrelate
Financial Statements

• ______________________
• ______________________
• ______________________
• ______________________
• ______________________
Income Statement

Exhibit 6: Income Statement: The Hershey Company

The Hershey Company
Income Statement
For the Year Ended December 31, 2010 (in millions)

<table>
<thead>
<tr>
<th>Revenues:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$5,671</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>$3,256</td>
</tr>
<tr>
<td>Selling and administrative expenses</td>
<td>1,426</td>
</tr>
<tr>
<td>Interest expense</td>
<td>96</td>
</tr>
<tr>
<td>Income taxes expense</td>
<td>299</td>
</tr>
<tr>
<td>Other expense</td>
<td>84</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 510</td>
</tr>
</tbody>
</table>

- Summary of revenue and expenses for a specific period of time (e.g., month, quarter, or year)
- Reports the change in financial condition due to the operations of a business
- Uses the Matching Concept
- Expenses for the period are matched against revenues for the same period

_____________ – ___________ = ________________
Retained Earnings Statement

Exhibit 7: Retained Earnings Statement: The Hershey Company

The Hershey Company
Retained Earnings Statement
For the Year Ended December 31, 2010 (in millions)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings, January 1, 2010</td>
<td>$4,148</td>
</tr>
<tr>
<td>Add net income</td>
<td>$510</td>
</tr>
<tr>
<td>Less dividends</td>
<td>283</td>
</tr>
<tr>
<td>Increase in retained earnings</td>
<td>227</td>
</tr>
<tr>
<td>Retained earnings, December 31, 2010</td>
<td>$4,375</td>
</tr>
</tbody>
</table>

- Reports changes in financial condition due to changes in retained earnings during a period
- Retained earnings is the portion of net income retained by the business
Balance Sheet

• Reports financial condition at a point in time.
• Measured by total assets and claims to those assets:

\[ \text{Assets} = \text{Total Assets} = \text{Liabilities} + \text{Stockholders' Equity} \]

Exhibit 8: Balance Sheet: The Hershey Company

The Hershey Company
Balance Sheet
December 31, 2010 (in millions)

<table>
<thead>
<tr>
<th>Assets</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 885</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>390</td>
</tr>
<tr>
<td>Inventories</td>
<td>534</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>141</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>1,438</td>
</tr>
<tr>
<td>Intangibles</td>
<td>647</td>
</tr>
<tr>
<td>Other assets</td>
<td>238</td>
</tr>
<tr>
<td>Total assets</td>
<td>$4,273</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$ 411</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>593</td>
</tr>
<tr>
<td>Notes and other debt</td>
<td>2,322</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>9</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$3,335</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stockholders' Equity</th>
<th>Amount (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock</td>
<td>$ 795</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>4,375</td>
</tr>
<tr>
<td>Repurchased capital stock and other equity items</td>
<td>(4,232)</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$ 938</td>
</tr>
<tr>
<td>Total liabilities and stockholders' equity</td>
<td>$4,273</td>
</tr>
</tbody>
</table>
Balance Sheet - Preparation

- **Step 1:** Each asset is listed and added to arrive at total assets
- **Step 2:** Each liability is listed and added to arrive at total liabilities
- **Step 3:** Each stockholders’ equity item is listed and added to arrive at total stockholders’ equity
- **Step 4:** Total liabilities and total stockholder’s equity are added together
- **Step 5:** Total assets must equal total liabilities and stockholders’ equity
### Statement of Cash Flows

**Exhibit 9: Statement of Cash Flows: The Hershey Company**

<table>
<thead>
<tr>
<th>The Hershey Company</th>
<th>Statement of Cash Flows</th>
<th>For the Year Ended December 31, 2010 (in millions)</th>
</tr>
</thead>
</table>

- **Net cash flows from operating activities** ........................................ $ 901
- **Cash flows from investing activities:**
  - Cash received from selling property, plant, and equipment .................. $ 2
  - Investments in property, plant, and equipment ................................... (201)
- **Net cash flows used in investing activities** ....................................... $(199)
- **Cash flows from financing activities:**
  - Cash receipts from financing activities, including debt ....................... $ 453
  - Dividends paid to stockholders ....................................................... (283)
  - Repurchase of stock ........................................................................... (169)
  - Other, including repayment of debt .................................................... (72)
- **Net cash flows used in financing activities** ......................................... $(71)
- **Net increase in cash during 2010** ...................................................... $ 631
- **Cash as of January 1, 2010** ............................................................... $ 254
- **Cash as of December 31, 2010** .......................................................... $ 885

- Reports the change in financial condition due to the changes in cash during a period
  - Net change in operating cash flows
  - Net change in investing cash flows
  - Net change in financing cash flows
Statement of Cash Flows – Operating Activities

• Net cash flows from operating activities is reported first.

• Cash flow from operating activities is a focus of creditors, employees, managers, suppliers and customers.

• Operating activities are transactions that involve the acquisition or production of products and services and the sale of those products or services to customers.
Statement of Cash Flows – Investing Activities

- Net cash flows from investing activities is reported second.
- Cash receipts from selling property, plant, and equipment are reported in this section.
- Cash used to purchase property, plant, and equipment is also reported in this section.
- Negative cash flow from investing activities is normally reported by an expanding company.
Statement of Cash Flows – Financing Activities

• Net cash flows from financing activities is reported third.

• Any cash receipts from issuing debt or stock are reported in this section.

• Cash payments on debt and dividends are also reported in this section.
### Integrated Financial Statements

**Exhibit 10: Integrated Financial Statements**

<table>
<thead>
<tr>
<th>The Hershey Company</th>
<th><strong>Balance Sheet</strong></th>
<th><strong>December 31, 2010</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>Liabilities</strong></td>
<td><strong>Stockholders’</strong></td>
</tr>
<tr>
<td>Cash $ 885</td>
<td>$ 3,335</td>
<td>$ 938</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Equity</strong></td>
</tr>
<tr>
<td>$4,273</td>
<td>$4,375</td>
<td></td>
</tr>
</tbody>
</table>

Total Liabilities + Stockholders’ Equity = $4,273

- **Operating act.** $901
- **Investing act.** $(199)
- **Financing act.** $(71)
- **Increase in cash.** $631
- **Cash, Jan. 1** $254
- **Cash, Dec. 31** $885

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- **Statement of cash flows** is linked to cash on the balance sheet.
- **Net income** from the income statement is linked to the retained earnings statement.
- **Retained earnings** is linked to the balance sheet in stockholders’ equity.

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Learning Objective 5

Describe eight accounting concepts underlying financial reporting
The Accounting “Rules”

Exhibit 11: Accounting Principles and Concepts

Financial Statements

- Income Statement
- Retained Earnings Statement
- Balance Sheet
- Statement of Cash Flows

Generally Accepted Accounting Principles (GAAP)

Accounting Concepts
- Business Entity Concept
- Cost Concept
- Going Concern Concept
- Matching Concept
- Objectivity Concept
- Unit of Measure Concept
- Adequate Disclosure Concept
- Accounting Period Concept

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Eight Concepts
End of Chapter 1