PART 1

Fundamentals of Accounting

chapter 1


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Introduction to Financial Accounting

In this chapter you will learn:

1. What financial accounting is
2. What economic information is conveyed in financial statements
3. How accounting information is used and why it is important
4. A framework for understanding accounting information
5. To begin to read actual financial statements by looking at excerpts from the reports of real companies

Conversations with managers quickly reveal contradictory views of accounting. To some, accounting is a dry exercise in "bean counting." To others, accounting seems hopelessly subjective. There is an old joke about a company president interviewing accountants. The accountant who got the job had the following interview:

President: "What's two plus two?"

Accountant: "I don't know. What number did you have in mind?"

While there may not be a consensus as to whether accounting is more "bean counting" or more shady dealing, most will agree that accounting is extremely important to the operations of an organization.

This chapter begins our study of accounting. It has three goals:

1. To describe what accounting is
2. To explore why it is useful
3. To introduce three dimensions critical to understanding and using accounting:
    - economic concepts
    - accounting conventions
    - institutional context

We begin by defining accounting. We then introduce basic accounting products, or financial statements. A real company's financial statements serve as a focal point for much of this introduction. Examples present and discuss several decisions that can be improved by considering accounting information. Finally, we present the framework of economic concepts, accounting conventions, and institutional context on which we base future chapters.

What Is Accounting?

OBJECTIVE: Learn what financial accounting is.

Accounting is the gathering and reporting of a financial history of an organization.

Accounting is the gathering and reporting of a financial history of an organization. This financial history requires a continual process of capturing financial data, organizing it into a useful set of accounting records, and issuing periodic financial reports to users. Accurate, up-to-date financial reports contain a great deal of valuable information for their users. The major goal of this book is to provide a clear understanding of how accounting works so you can make the most of this information.

Union Plaza Background

Consider the case of the Union Plaza Hotel and Casino (hereafter, Union Plaza), a company that operates the Plaza Casino and a hotel with 1,037 guest rooms on Main Street in Las Vegas, Nevada. Formed in 1962, Union Plaza experienced phenomenal changes along with the Las Vegas area and within the gaming industry. New hotels and casinos opening up on the Las Vegas "Strip" included the massive Bellagio, a $1.6 billion development. Relative to when it began in 1962, the Union Plaza faces competition from a much wider range of sources, including Atlantic City, gaming on riverboat casinos in places such as St. Louis, Missouri, and Bay St. Louis, Mississippi, and casinos on Native American reservations across the United States.

According to its management, 2001 was a particularly difficult year for Union Plaza. Increased competition for the middle class customer necessitated lower prices, at the same time costs of goods and services went up. On top of everything else, the terrorist attacks of September 11 and their aftermath severely dampened tourism, costing Union Plaza nearly one-half of its wholesale room bookings in the following three months.

Plenty of events challenged Union Plaza in 2001, and we might expect them to significantly affect the company. Shortly, we will show you actual Union Plaza financial statements that attempt to capture the company's financial history and accurately convey it to users. However, getting the most from the information in accounting reports requires that we recognize three important factors that shape the construction of the financial statements.

Framework for Understanding Accounting Information

Economic concepts are the ideas that guide the construction of accounting reports.

Accounting conventions are the rules and customs of accounting for applying economic concepts to practical situations.

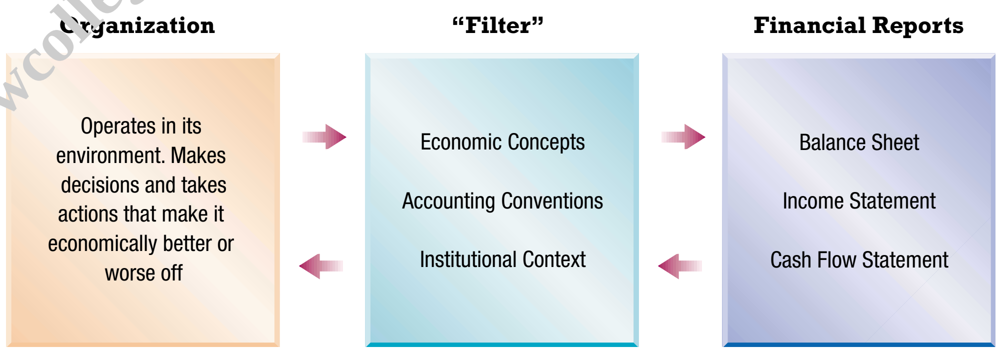
Institutional context consists of the environment that shapes the consequences of adopting specific accounting conventions.

Three aspects determine the information in accounting reports: economic concepts, accounting conventions, and institutional context. **Economic concepts** are the ideas that guide the construction of accounting reports. **Accounting conventions** are the rules and customs of accounting for applying those economic concepts to practical situations. **Institutional context** consists of the environment that shapes the consequences of adopting specific accounting conventions.

Even though estimates and predictions play a role, the "wiggle room" in an accounting history is limited by the economic concepts that guide it, the accounting conventions that govern its implementation, and the institutional context that disciplines its writers and users. Extracting the most information in accounting reports requires understanding these economic concepts (your other business classes should help here) and accounting conventions and appreciating the institutional context in which the concepts and conventions are applied.

Figure 1.1 illustrates the relationship between financial reports and the economic status of the organization. Users of financial statements must understand the "filtering" process in order to make correct assessments of the true economic status of the organization. Accounting numbers supply only approximations to economic reality; forgetting about the filtering process jeopardizes the quality of decisions. It is not so important what the accounting numbers are. Their importance lies in what they mean.

Figure 1.1
Financial Statement Construction Process



The short answer to the question, What is accounting?, might read as follows:

Accounting is the process of gathering, compiling, and reporting the financial history of an organization. Accounting's financial history is distinguished by the use of economic concepts, accounting conventions, and institutional pressures that guide its construction.

The fact that both concepts and conventions play roles in the accounting process tells us that accounting has both logical and social dimensions. To a student, this duality can be frustrating. Accounting lies somewhere between a perfectly logical science in which every assertion can either be proven correct or demonstrated to be false, and a totally subjective discipline where the validity of any statement can never be proven or disproven with certainty. Although the presence of both logical and social dimensions strains our ability to maintain a smooth flow of material, we believe it is essential to keep both dimensions in view, because denying either seriously impairs our understanding of accounting. Complete knowledge of the concepts and conventions available can be brought to bear only when the institutional context within which the reports are prepared and used is understood.

Financial Histories: The Financial Statements

OBJECTIVE:
Learn what economic information is conveyed in financial statements.

An organization's financial history concentrates on its economic resources. Accounting periodically provides a **balance sheet,** which lists the economic resources available to an organization at a point in time. A balance sheet also describes an organization's commitments to give up economic resources to other organizations and individuals. Finally, a balance sheet shows the excess (or deficit) of resources available over those committed.

A **balance sheet** is a list of resources available, resources committed, and the difference between the two.

An **account** is a record of a specific category of asset, liability, equity, revenue, or expense.

Exhibit 1.1 shows a balance sheet for Union Plaza as of December 31, 2001. The balance sheet always contains the name of the organization (entity) and the exact date of the report because the balance sheet provides a snapshot of the organization's financial condition at a particular point in time. Union Plaza's balance sheet describes its economic resources (assets) and economic commitments (liabilities) through a set of categories, or **accounts.**[1] Union Plaza's assets include **Cash and Cash Equivalents; Accounts Receivable; Inventories of Food, Beverage, etc.; Prepaid Expenses; Property and Equipment;** and **Other Assets.** Its liabilities include **Accounts Payable, Accrued Liabilities, Other Current Liabilities, Long-Term Debt,** and **Obligations under Capital Leases.** The difference between its assets and liabilities is called Stockholders' Equity. Union Plaza's Stockholders' Equity consists of **Common Stock, Additional Paid-In Capital,** and **Retained Earnings,** less the value of its own shares it has repurchased as **Treasury Stock**.

Exhibit 1.1
Union Plaza Balance Sheet

Union Plaza Hotel and Casino, Inc. and Subsidiaries
Consolidated Balance Sheet as of December 31, 2001
(dollars in thousands)

ASSETS		**LIABILITIES**	
Cash and cash equivalents	$ 3,552	Accounts payable	$ 2,441
Accounts receivable, net	786	Accrued liabilities	2,353
Inventories of food, beverage, etc.	423	Other current liabilities	609
Prepaid expenses	793	Total current liabilities	$ 5,403
Total current assets	$ 5,554		
		Long-term debt	32,900
Property and equipment:			
Land	$ 7,012	Obligations under capital leases	1,582
Buildings	48,040	TOTAL LIABILITIES	$39,885
Leasehold improvements	3,564		
Furniture and equipment	31,659	STOCKHOLDERS' EQUITY	
	$90,275		
Less accumulated depreciation		Common stock	$ 750
and amortization	(55,903)	Additional paid-in capital	$ 5,462
Net property and equipment	$34,372	Retained earnings	$14,525
Other assets	587	Less treasury stock	(13,897)
		TOTAL STOCKHOLDERS' EQUITY	$ 628
		TOTAL LIABILITIES AND	
TOTAL ASSETS	**$40,513**	**STOCKHOLDERS' EQUITY**	**$40,513**

Cash equivalents are items such as bank accounts, Treasury bills, and money market funds that can readily be turned into cash.

Receivables are money owed to Union Plaza for goods sold or services provided.

Accounts payable are money owed to suppliers for items purchased from them.

Accrued liabilities are money owed to providers of goods or services.

Retained earnings are past earnings not distributed to stockholders.

Note the balance:
Total assets = Total liabilities and Stockholders' equity

Numbers are attached to these lists of resources (assets) and commitments (liabilities). One of the major challenges of accounting is to understand the meaning of these numbers, which attempt to measure the effects of actions and decisions taken by Union Plaza's management but are subjected to the accounting filtering process. The numbers

[1]We give more rigorous definitions of assets and liabilities in Chapter 2.

actually have a variety of meanings. For example, we will see that the $786 thousand assigned to Accounts Receivable is an estimate of the actual amount Union Plaza expects to collect from the amounts owed to it by its customers. The $34,372 thousand assigned to Property and Equipment is another matter. The $7,012 thousand for land is simply the amount Union Plaza paid for the land. The amount Union Plaza paid is not necessarily a good approximation of what the land would bring if sold. The Buildings, Leasehold Improvements, and Furniture and Equipment amounts are also what Union Plaza paid. A deduction applies, however, for Accumulated Depreciation and Amortization. Cost less Accumulated Depreciation is usually not a good approximation of what the equipment would bring if sold.

The numbers on the balance sheet, whatever their origin, do add up; that is, the total of all of the assets, $40,513 thousand, is the same as the total of all liabilities and stockholder equity. For that reason it is called a balance sheet. The resources (assets) are equal to (balance) the liabilities (commitments) and stockholder equity (the excess of resources over commitments).

An **income statement** lists the resources acquired and consumed through an organization's operations over a period of time.

Accounting's financial history also describes the flows of economic resources into and out of an organization during a period of time. An **income statement** lists the economic resources acquired by an organization through its operations during a period of time. It subtracts the economic resources consumed through operations during a period of time.

Exhibit 1.2 shows an income statement for Union Plaza. The income statement is for the year ended December 31, 2001. It describes the flows of Union Plaza's economic

Exhibit 1.2

Union Plaza Income Statement

Revenues equal the dollar value of all the products and services Union Plaza sold during the period (the inflow of resources from sales).

Operating expenses are the dollar value of the costs incurred by Union Plaza in running its business.

Food and beverage expense is the cost of all the food and beverage items recorded as sold under Revenues.

General administrative expense includes the resources consumed for general administrative functions during the period.

Depreciation and amortization expense is the allocation of part of the cost of property and equipment to the period.

Union Plaza Hotel and Casino, Inc. and Subsidiaries
Income Statement for the Year Ended December 31, 2001
(dollars in thousands)

REVENUES	
Casino	$37,807
Food and beverage	10,351
Rooms	11,110
Other	2,524
GROSS REVENUES	61,792
Less promotional allowances	(6,922)
NET REVENUES	54,870
OPERATING EXPENSES	
Casino	$22,865
Food and beverage	8,997
Rooms	4,294
General and administrative	5,155
Entertainment	591
Advertising and promotion	1,329
Utilities and maintenance	6,712
Depreciation and amortization	4,130
Provision for doubtful accounts	44
Other costs and expenses	1,246
TOTAL OPERATING EXPENSES	$55,363
OPERATING INCOME (LOSS)	$ (493)
OTHER INCOME (EXPENSE)	
Interest income	3
Loss on sale of assets	(159)
Interest expense	(2,265)
TOTAL OTHER INCOME (EXPENSE)	(2,421)
NET LOSS	$(2,914)

resources. Increases in resources from operations are called revenues. Decreases in resources due to operations are called expenses.[2]

Union Plaza's revenues are classified as Casino, Food and Beverage, Rooms, and Other. Near the bottom of the income statement, we can see that Union Plaza also had some Interest Income. Union Plaza's expenses during that same time period are Casino, Food and Beverage, Rooms, General and Administrative, Entertainment, Advertising and Promotion, Utilities and Maintenance, Depreciaition and Amortization, Provision for Doubtful Accounts, Interest Expense, and Other. Union Plaza took a Loss on Sale of Assets. All told, Union Plaza recorded a net loss for the year of $2,914 thousand.

Numbers are attached to each type of revenue and expense. For example, the revenue raised by sales of Food and Beverage was $10,351 thousand. These receipts come from restaurant and bar sales. The expense of $8,997 thousand for Food and Beverage is the cost of the food and beverage sold in the restaurant and bar. In fact, if the Union Plaza was only a restaurant and bar and had revenues only from those sources, the expense for food and beverage would probably be called Cost of Goods Sold or Cost of Sales.

As with the balance sheet, the revenue and expense numbers on income statements result from numerous calculations, and we will learn to understand them.

The difference between revenues and expenses is Net Income if positive and Net Loss if negative. Net income represents an increase in Stockholders' Equity on the balance sheet because net income is a net increase in resources over a period. Net loss represents a decrease in Stockholders' Equity, because it is a net decrease in resources over a period. Thus, an income statement helps explain why one of the numbers in the balance sheet, Retained Earnings, changes as a result of an organization's activities.

A **cash flow statement** describes the flows of cash into and out of an organization over a period of time.

Cash is such an important economic resource, it deserves special attention. A third financial statement, the **cash flow statement,** describes the flows of cash into and out of an organization during an accounting period. The cash flows are classified as one of three types of activities that generated them: operating, financing, or investing activities. The accounting choices behind these classifications will be discussed in greater detail later.

Exhibit 1.3 shows the statement of cash flow for Union Plaza. Like Union Plaza's income statement, the cash flow statement is for a period of time, the year ended December 31, 2001. Union Plaza's operating cash flows contributed $1,066 thousand in cash, while its investing activities consumed $1,131 thousand and its financing activities generated $282 thousand. Together, the three amounts tell us that Union Plaza's cash increased by $217 (in thousands) over the year.

Net cash flow from operating activities	$ 1,066
Net cash flow from investing activities	(1,131)
Net cash flow from financing activities	282
Net cash flow from all three sources	$ 217

Also like income statements, cash flow statements relate to a change in a balance sheet number. The cash flow statement always provides a reconciliation of how the cash balance changed from the beginning to the end of the period.

We will see many examples of balance sheets, income statements, and cash flow statements. Knowing how these statements are constructed and how they relate to each other will enable you to get the most information out of a set of financial statements. But why go through all the trouble? What are financial statements used for anyway? The next section describes several main categories of decisions that can be improved by using the information contained in financial statements.

[2]We give more formal definitions of revenues and expenses in Chapter 3.

Exhibit 1.3
Union Plaza
Cash Flow Statement

Operating activities relate to actions intended to generate net income for Union Plaza.

Investing activities are actions taken to acquire or dispose of productive assets of the company.

Financing activities relate to actions that generate receipts from or payments to suppliers of money to the firm. Typically these suppliers are investors in Union Plaza's common stock or entities that loaned it money (debt holders).

Union Plaza Hotel and Casino, Inc. and Subsidiaries
Consolidated Statements of Cash Flows for the Year Ended December 31, 2001
(dollars in thousands)

CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from customers	$54,761
Cash paid to suppliers and employees	(51,314)
Interest received	3
Interest paid	(2,384)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	$ 1,066
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sale of property and equipment	$ 42
Purchase of property and equipment	(1,173)
NET CASH USED IN INVESTING ACTIVITIES	$(1,131)
CASH FLOWS FROM FINANCING ACTIVITIES	
Principal payments on short-term contracts	$ (158)
Proceeds from long-term debt	2,000
Principal payments on long-term debt	(641)
Principal payments on capital leases	(919)
NET CASH PROVIDED BY FINANCING ACTIVITIES	$ 282
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	$ 217
CASH AND CASH EQUIVALENTS, at beginning of the year	3,335
CASH AND CASH EQUIVALENTS, at end of the year	$ 3,552

Review Questions

1. Classify each of the following items as either an expense (E), a revenue (R), an asset (A), or a liability (L): Cash, Buildings, Salaries of the sales force, $5 owed to a company for work performed, Mortgage due to a bank, Sales.

2. Classify each of the following as either operating (O), investing (I), or financing (F) in a statement of cash flows: Wages paid to production workers, Cash received from a bank in the form of a mortgage, Cash dividends paid to shareholders, Cash paid to a supplier of inventory, Cash paid to purchase a new machine.

Why Study Accounting?

OBJECTIVE:
Learn how accounting information is used and why it is important.

Managers and others making financial decisions tend to be pragmatic people interested in the problems of here and now. They are interested in history only to the extent that it informs present or future decisions. The financial history summarized in an organization's financial statements is intended to do just that: inform present and future decisions. A well-designed set of statements will contain useful information about:

- The economic consequences of past decisions
- The current economic performance of the organization
- The economic performance of the organization's management
- The current economic status of the organization

Decision Making

Many decisions can be improved with accounting information. For example, a manager might make a better decision as to whether to extend credit to a customer by knowing the customer's current indebtedness and past payment history. Information about current debt might best be found in the customer's accounting records. Information about past payment history might be found in the accounting records of the manager's firm.

An investor considering whether to buy a share of stock in IBM for $125 will improve her chances of making a wise decision by inspecting IBM's financial reports. These reports help investors identify and assess a company's business strategies, its risks, its financial resources, its financial obligations, and whether it has been able to operate at a profit in the past.

If the management of Union Plaza wants to borrow money from a bank to finance the purchase of new equipment, it improves its chances of getting the loan by providing information that shows that the loan and interest are likely to be repaid. This type of evidence can be obtained from accounting records and reports.

A regulator of a public utility improves the chances of making a wise decision about the rates it allows the utility to charge its customers by looking at the utility's accounting reports. The regulator assesses whether past prices were sufficient to maintain quality service and adequate financial returns, or too generous given the services received by customers.

A potential donor informs his decision about whether to donate to the Guggenheim Museum by examining the museum's accounting statements. These statements help in evaluating the resources available to the organization and whether donated resources are likely to be used for the intended purposes.

A member of the compensation committee of the board of directors of the General Motors Company trying to determine how the president of GM is to be compensated likely uses accounting numbers to measure the president's performance. These measures might well include comparisons with the reported results of other companies in the automobile industry.

A potential competitor of Union Plaza improves its chances of making wise strategic decisions by becoming thoroughly familiar with Union Plaza's accounting reports.

A judge, determining the damages to be paid by a defendant who engaged in unfair business practices, improves the chances of making a wise decision by examining accounting records of the profits obtained by those practices.

These examples illustrate the many uses of accounting information. They indicate the high value of accounting information.

Accounting Is More Than Just Numbers

All the users in the examples benefit by being aware of more than just the numbers and descriptions in the accounting reports. The economic concepts and accounting conventions underlying the reported numbers are important to understand. Without economic concepts to provide some meaning, accounting numbers are gibberish. Economic concepts help determine what it is we are trying to measure. Often the underlying focus of measurement is not exactly clear, however, and accounting measurements are not pure. Different accounting methods may reasonably be aimed at describing the same underlying economic attribute. Knowledge of accounting conventions helps us to understand which particular method generated the numbers at hand and enables us to better place these numbers in context. It frequently also helps us to see what items of economic importance are left out of the statements altogether.

In addition to economic concepts and accounting conventions, the information in financial statements depends on a human element. Accounts (records of specific categories of assets, liabilities, stockholder equity, revenues, and expenses) are kept and reports are made by people whose character and circumstances affect their reliability. For example, it is not unusual for record keeping to be low on the priority list of managers running a rapidly growing new enterprise. The day-to-day pressure of keeping up with growing demand, late suppliers, new employees, and so on, overwhelms their ability to properly record what is happening. And it goes without saying that large-scale financial fraud in established organizations invariably involves coverups in the accounting records.

Many aspects of the accounting environment attempt to compensate for this human side of accounting. The public accounting reports of major corporations must be audited by independent, certified public accountants (CPAs) who face considerable liability when misleading accounting reports are issued. Managers of companies are also liable for issuing misleading reports. In addition, managers and companies develop reputations for honesty (or dishonesty) among shareholders, the business press, and their peers. These forces on managers and auditors, along with economic concepts and accounting conventions, help discipline the financial reporting process.

8/98 Investor lawsuit against Daou claims Daou used inappropriate accounting principles to show profit of 1 cent per share when it lost 16 cents per share.

3/99 Oxford Health Plans shareholders sue company for securities fraud and accuse auditors of propping up share value with misleading reports.

3/99 Cendant Corp. files a lawsuit against its auditors, alleging failure to detect fraudulent funds when auditing one of the companies that merged to form Cendant.

12/99 Ernst & Young agrees to pay $335 million to settle shareholders' accusations that its audits of Cendant Corp. were faulty.

1/01 SEC Chairman Pitt recommends new governing body to oversee accountants.

3/02 Andersen loses clients after Enron debacle.

It all adds up to a pretty complex situation for users of accounting reports. This complexity is what makes accounting worth studying. After all, it is important to know how to measure lengths and weights. The numbers produced by these measurements are useful in a variety of circumstances, but intense study of such measurements is worthwhile only for a few people. For most people, a basic knowledge of length and weight measurement is more than sufficient for their purposes.

This is not true of accounting. Unlike measurements of length and weight, which produce concise, well-understood numbers, accounting produces scores of numbers with vague, often misunderstood implications. The measurement of economic resources is considerably more complicated and subjective than the measurement of length or weight. Accounting produces far more than numbers. An accounting report contains labels for the numbers (i.e., account titles), summaries of the accounting procedures applied, multiple measurements of the same items, and warnings about potential obligations not yet included in the numbers presented.

Exhibit 1.4 contains excerpts from footnote 1 in Union Plaza's 2001 annual report. It presents a summary of the accounting methods used to compile its financial statements. For example, Union Plaza explains what it considers to be cash equivalents. The note talks about how Union Plaza determines the revenue from its casino, and a bit about Union Plaza's accounts receivable. The note explains that the number associated with Property and Equipment on its balance sheet represents the acquisition cost of the property and equipment. Systematic adjustments are made to record the downward movement of value (depreciation) associated with the passage of time. The note reveals that Union Plaza includes complementary items given to customers in gross revenues, then deducts them as promotion allowances to calculate net revenue.

Exhibit 1.4
Union Plaza Summary of Accounting Policies

Union Plaza Hotel and Casino
(Excerpts from footnote 1: A Summary of Significant Accounting Policies)

The following summarizes the significant accounting policies of the Company: For purposes of the statement of cash flows, the Company considers all highly liquid investments purchased with a maturity of three months or less to be cash equivalents.

In accordance with common industry practice, the Company recognizes as casino revenue the net win (which is the difference between amounts wagered and amounts paid to winning patrons) from gaming activities. Credit is extended to certain casino customers and the Company records all unpaid advances as casino receivables on the date credit was granted. Allowances for estimated uncollectible casino receivables are provided to reduce these receivables to amounts anticipated to be collected.

Property and equipment are stated at cost. Depreciation is computed using the straight-line method.

The retail value of admissions, food and beverage and other complimentary items furnished to customers without charge is included in gross revenue and then deducted as promotional allowances.

Although this information may seem a bit overwhelming, understanding what it means is within reach. As we go through the way accounting works, you will learn what is meant by these and other accounting methods.

For other examples of accounting disclosures, consider the case of Kmart. Exhibit 1.5 contains part of footnote 1 found in the 1998 Kmart Corporation annual report. Kmart, one of the largest retailers in the United States, tells in this note what certain accounting numbers—the values associated with inventory on its balance sheet—would be if they had used the FIFO method instead of the LIFO method of accounting for inventories. In inventory accounting, accountants disclose multiple measures. This explanation is important because not all corporations use the same method to compute the inventory number on their balance sheet. In order to compare the inventory values of two different companies, we would need to know the basis for those numbers.

Exhibit 1.5
Kmart Summary of Accounting Policies

Kmart Corporation
(Excerpt from footnote 1: A Summary of Significant Accounting Policies)

INVENTORIES: Inventories are stated at the lower of cost or market, primarily using the retail method. The last-in, first-out (LIFO) method, utilizing internal inflation indices, was used to determine the cost for $6,148, $5,990, and $5,883 of inventory as of year end 1998, 1997, and 1996, respectively. Inventories valued on LIFO were $407, $457, and $440 lower than amounts that would have been reported using the first-in, first-out (FIFO) method at year end 1998, 1997, and 1996, respectively.

Exhibit 1.6 presents part of a Kmart Corporation footnote explaining future commitments and contingencies. In 1998, the Sports Authority (TSA) chain, owned by Kmart, experienced operating and financial difficulties. The footnote indicates that under certain conditions, Kmart guaranteed to pay for TSA leases. In light of its financial troubles, Kmart attempted to change the terms of the guarantees.

The purpose of going through these footnotes is to firmly establish that although accounting statements contain a great deal of information, financial disclosure is a complex business. Accounting is important and complex enough to be worth studying, and it requires an organized approach. We begin this organized approach by discussing economic concepts, accounting conventions, and the institutional environment.

Exhibit 1.6

Kmart Footnote Explaining Commitments and Contingencies

Kmart Corporation
(Excerpt from commitment and contingency footnote)

THE SPORTS AUTHORITY

On October 6, 1998, TSA announced that it would take a $55 after-tax charge, as a result of store closings, inventory writedowns and other charges and costs, and that operating results for the third quarter of 1998 would be weaker than expected. In October 1998, TSA announced that it amended certain aspects of its bank credit agreement, including modifying certain financial covenants in light of the restructuring charge. Pursuant to that amendment, TSA also granted its bank lenders a security interest in its inventory and certain accounts receivable. On December 9, 1998, in its third quarter 10-Q filing, TSA noted that its ability to satisfy ongoing working capital and capital expenditure requirements depends on successfully negotiating a new credit facility prior to the expiration of its bank credit agreement in April 1999.

Kmart's rights and obligations with respect to its guarantee of TSA leases are governed by a Lease Guaranty, Indemnification and Reimbursement Agreement dated as of November 23, 1994 (the "LGIRA"). Kmart and TSA are presently in discussions to amend and restate the LGIRA, the terms of which have not been finalized, in connection with TSA's refinancing activities related to the procurement of a new three-year credit facility prior to April 1999.

Review Questions

1. List several economic decisions that rely on accounting information.
2. Why do financial statements have footnotes, and what kinds of information might you find in them?

Economic Concepts

OBJECTIVE: Learn a framework for understanding accounting information.

Three main economic concepts are at the heart of accounting: financial value, wealth, and economic income. Financial value is the foundation upon which wealth and income measurement rest. A financial value is an amount of money. As we saw in Union Plaza's financial statements, accounting reports contain many monetary amounts. To understand what accounting reports tell us about an organization's economic resources, we must understand what financial values are and how accounting's monetary amounts relate to them. We must appreciate the ideal measurement of wealth and income and how accounting's measurements stack up against it.

Financial Value

The **financial value** of an item is the amount of money it would bring if sold.

The **financial value** of an item is the amount of money it would bring if sold. For instance, your house might have an assessed value of $200,000 for property tax purposes, but if you wish to sell it and the best offer is $220,000, then its financial value is $220,000. In theory, financial value is a straightforward and useful concept, but in practice it becomes more difficult. How can we know how much an item would fetch if we don't actually sell it?

One way to assess the financial value of an item without selling it is to look at the sale prices of the same, or nearly the same, thing. This method tends to work best if the item is traded in a well-functioning market. For example, bushels of corn and ounces of gold are constantly traded under conditions that give us a lot of confidence in the amount a bushel of corn or an ounce of gold would bring if sold.

An example of the traditional way by which financial value is established—trading on the floor of a stock exchange. How will technology innovations such as internationally-linked computers that enable round-the-clock trading affect the way financial value is determined in the future?

Characteristics of well-functioning markets:
- *competitive*
- *low transaction costs*
- *organized and regulated*

Well-functioning markets exhibit three characteristics: they are competitive, they have low transaction costs, and they are organized and regulated. For example, the markets for gold and corn are highly competitive. Corn and gold are commodities. One ounce of gold or one bushel of corn is as good as any other. Many people produce corn and gold, and many people have uses for them. Other people specialize in trading corn and gold. A market value that gets out of line with financial values provides incentive to speculators to buy or sell until the aggregate effect leads the prices to adjust to proper financial values.

The markets for gold and corn use up relatively few resources in their operation, which is reflected in the low transaction charges that the markets impose on traders (usually a fraction of one percent of the value of the trade). Low transaction costs are important because they lead the prices in the markets to reflect the financial values of the items being traded, without being unduly influenced by the costs to the traders of implementing their trades. Low transaction costs enable markets to closely track small changes in financial values. With high transaction costs, a change in financial value might not be reflected in the trading price because the cost of the trade exceeds the change in financial value. Low transaction costs in the gold and corn markets help their prices stay in line with financial values.

Corn and gold trade in organized, regulated exchanges. These exchanges use standard definitions of tradable items, rules and conventions for making trades, and procedures for policing traders. If better, less costly ways for an exchange to organize its activity are discovered, competition from other exchanges will pressure it to adopt them. The prices on gold and corn markets then reflect value as closely as humanly possible.

Wealth

An organization's **wealth** is the sum of the financial values of all the things it owns.

An organization's **wealth** is the sum of the financial values of all the things it owns. Economists and accountants break the wealth calculation down into parts. Some of the things an organization owns—for example, its delivery trucks—are useful to others who would give an organization money to acquire them. These things are expected to generate future benefits (which is why the organization owns them in the first place) and are called *assets.* In contrast, other things an organization owns involve future sacrifices. For example, in order to sell a piece of machinery the organization may have to give a warranty to the purchaser. This warranty likely creates an obligation to expend resources in the future. The things that involve future sacrifices of resources are called *liabilities.*

Separating assets and liabilities lets us think of an organization's wealth as the difference between the financial value of its assets and the financial value of its liabilities. This difference is called *equity:*

ASSETS − LIABILITIES = EQUITY

The most important identity in accounting: Assets = Liabilities + Equity

This identity is just a rewriting of the balance sheet description:

ASSETS = LIABILITES + EQUITY

An *identity* is more than an equation, it is a *definition*. Once we determine assets and liabilities, we must know equity. So really, the balance defines equity by giving us the totals for assets and liabilities. This identity holds at every point in time. Accounting's financial history uses this identity to organize its portrayal of economic resources so much that it is often called the fundamental accounting identity. *It is the most important identity in this book!*

Union Plaza's balance sheet reflects this way of describing an organization's resources. As shown in Exhibit 1.1, at December 31, 2001, Union Plaza had assets of $40,513 thousand and liabilities of $39,885 thousand. The difference between the two is the stockholders' equity of $628 (in thousands):

Assets	$40,513
Liabilities	39,885
Equity	$ 628

Economic Income

An organization's **economic income** over a period is the change in its wealth, excluding capital transactions with its owners.

Wealth captures economic resources at a point in time, but we are also interested in describing resource flows. An organization's **economic income** over a period is the change in its wealth, excluding capital transactions with its owners. The idea behind economic income is to describe an organization's success in using its economic resources in a period. Although contributions from owners increase the wealth available to an organization, the increase is not generated by use of that organization's resources. Similarly, payments to owners are not resources consumed by an organization; they are distributions of its resources.

Union Plaza's accounting income statement reflects this thinking. The income statement describes the changes in wealth stemming from resources brought into the company by its operations (revenues), less the resources consumed during the period (expenses). Resources distributed to owners of corporations are called dividends and are reported in the statement of cash flows. The financing section of Union Plaza's cash flow statement in Exhibit 1.3 contains no amounts for dividends, so we can infer that Union Plaza did not distribute any cash to its owners in 2001.

Importance of Financial Value, Wealth, and Economic Income in Accounting

Accounting's use of monetary amounts, its descriptions of resources, obligations, and equities as of a given date in balance sheets, and its descriptions of resource flows arising from revenues and expenses in income statements parallel the economic concepts of financial value, wealth, and economic income. The financial value of an item is clearest within a well-functioning market for it. Measures of wealth are most directly meaningful when each asset and liability component of wealth has a clear financial value.

Economic income is the clearest when changes in wealth can be comprehensively identified and classified as being or not being a contribution from or distribution to an owner.

Measurement of financial values, wealth, and economic income under ideal conditions is useful for learning about accounting; but to put accounting in proper perspective, we must address problems of applying these concepts in practice. Practical problems arise with each of these economic concepts. Consider the issue of financial value. All organizations own many resources whose financial values are not readily determinable at all points in time.

Economic reality:
• Timing
• Uncertainty
affect the financial value of a resource or obligation.

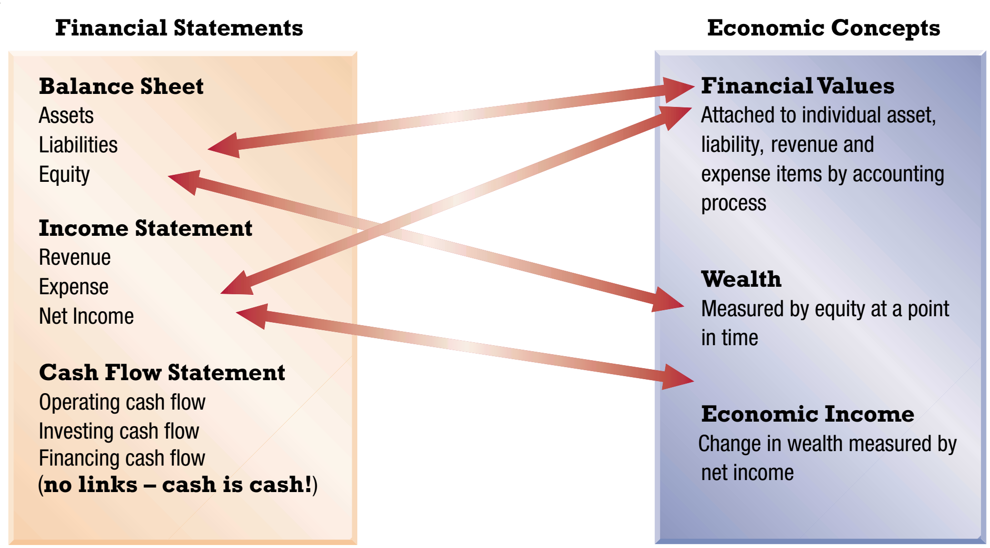
Two main features of ***economic reality*** cause particular problems with assessing the financial value of a resource or obligation: the ***timing*** and ***uncertainty*** of its ultimate benefit or cost. For example, Union Plaza's hotel, built several years ago, occupies a unique location. Potential buyers for it are probably few. Further, a potential buyer might be uncertain about its future profitability. Things might turn around and the hotel might start producing profits immediately. On the other hand, competitors might intensify their efforts to lure away Union Plaza's customers, the "hassle factor" involved in air travel might get worse and further depress tourism, and costs might continue to rise.

Assuming that the hotel is put up for sale, finding the right buyer and negotiating the terms of the sale are time-consuming, expensive processes. Transaction costs are high.

Assessing the financial value of Union Plaza's hotel is, therefore, a challenging task—challenging, but not impossible. The financial values for some items are not available at all. For example, Union Plaza's management possesses a great deal of valuable knowledge about how to run a hotel and casino business. This type of knowledge cannot be directly bought and sold, at least partly because we are uncertain about how to even define it.

Because financial values for all items are not available, wealth measurements are incomplete. As a result, income measurements fall short of capturing all changes in wealth. We should not give up on the concepts of economic value, wealth, and economic income, however, just because we cannot make the ideal measurements. By adopting conventions of accounting measurement and disclosure, we construct accounting counterparts to these ideals and provide information about how they are related. Figure 1.2 shows the relationship between the financial statements and economic concepts.

Figure 1.2
Relationship between Financial Statements and Economic Concepts



In the example of the hotel, we can make several observations. First, at the time it was built, the cost was probably a good indication of the value because the land, steel, glass, labor, and other materials and services used in constructing the hotel were purchased in markets. Their financial value at the time was likely to be closely tied to their cost to Union Plaza, who purchased them for construction of the hotel. Another useful observation is that the hotel cannot last forever. It will either be sold, in which case another well-determined market value will be established for Union Plaza, or it will continue to be used, in which case its financial value will likely diminish to zero. In any case, we expect its financial value to fall as it is used, as it depreciates. Union Plaza can decide on a reasonable schedule on which to depreciate the recorded value of the hotel in its accounting records, and be assured that errors in valuation will either be corrected by a market transaction (sale of the hotel) or go to zero in the long run if it is continually held.

Union Plaza:
Plant and equipment valuation

> Plant and equipment are carried at cost less accumulated depreciation and amortization.

Communicating to users of the accounting reports what is being done in the accounts will likely be easier if a fairly standard set of approaches to measurement problems is established. These standard ways of handling practical measurement problems are accounting conventions.

Accounting Conventions

Accounting conventions arise from practical matters and inevitably encompass human judgments, human interactions, and compromises. These conventions will be more easily understood and carry more credibility if they are commonplace. **Generally accepted accounting principles (GAAP)** are commonly understood and accepted conventions for gathering, organizing, and reporting accounting's financial history of an organization.

Generally accepted accounting principles (GAAP) are commonly understood and accepted conventions for gathering, organizing, and reporting accounting's financial history of an organization.

GAAP conventions guide accounting valuation, recognition, and disclosure.

Accounting valuation is the act of assigning an item a monetary value to be reported in the balance sheet.

Recognition is the act of recording an item in the accounting records.

Disclosure is the act of providing information about the organization and the construction of its accounting reports.

Nature of Accounting Conventions

GAAP apply to one or more of three broad areas. One is **accounting valuation:** GAAP help specify what values are placed on the items reported. If a solid financial value exists, it is likely that GAAP use that value. If a solid financial value does not exist, GAAP provide guidance and restrictions on what accounting values are placed in the accounting records. For example, in Exhibit 1.4 we saw how Union Plaza values property and equipment.

Recognition is the second area. **Recognition** is the act of recording formally some item in the accounting records. Consider an advertising campaign. The future benefits it creates, if any, do not have a readily determinable financial value. Should any amount related to the future benefits of the advertising campaign be recognized as an asset? Consider a sale on credit. When should an increase in assets be acknowledged and revenue recognized? If financial values were clear and wealth measurement all-encompassing, the issue of recognition would not arise. But in practice, many changes in wealth are not automatically known. GAAP guide their recognition.

The third area is disclosure. **Disclosure** is the act of providing information about the organization and the construction of its accounting reports. Calculating and attaching accounting values, constructing balance sheets, and compiling income statements are inexact sciences. GAAP dictate disclosures of measurement methods, assumptions, and the results of adopting alternative sets of assumptions that add to the information content of the accounting reports.

Factors Affecting Accounting Conventions

Accounting conventions tend to arise somewhat randomly as practical problems present themselves. GAAP are not logically constructed from a few underlying ideas, and getting

Factors affecting GAAP:
• market richness
• complexity of transactions
• form of organizaiton

all their details requires some memorization. The process of remembering GAAP for an item can be made somewhat easier by assessing three factors. The first is the ***richness of the market*** in which the item of interest is being traded (is it corn or gold, or a specialized building?). A rich market is a well-functioning one in which many buyers and sellers compete for relatively uniform goods in a setting with low transaction costs. Examples include the corn and gold markets we spoke of earlier. When markets are rich, GAAP tend to use market valuations to drive the accounting.

The second assessment is the ***complexity of the transactions*** used to trade the item. A straightforward exchange of cash for a Big Mac™ is a simple transaction. The exchange of the services of a chief executive officer of a corporation for a salary, possible bonus, generous pension plan, stock options, and other perquisites is a complex transaction. It becomes more difficult to come up with accounting values for what is given and what is received by both parties to this transaction. When transactions are simple, GAAP tend to be simple. When transactions are complex, GAAP tend to be complex.

The third assessment is the ***form of the organization*** for which the accounting history is being written. Different organizations engage in different activities, produce accounting reports for different constituencies with different uses for reports, and face different underlying economic circumstances. GAAP take into account the form of the organization. GAAP for sole proprietorships (single-owner companies) and partnerships differ from GAAP for corporations, which differ from GAAP for not-for-profits, which differ from GAAP for governments. For example, proprietors continually make contributions of many different types of resources to their businesses. When they withdraw resources, it is unclear whether it is a return for their financial resources contributed (a dividend) or for their time (wages). Proprietorship accounts do not distinguish the nature of a proprietor's withdrawals.

Similarly, in contrast to public corporations, not-for-profit organizations do not earn income for a set of owners, nor do they typically produce income statements. Yale University attempts to cover all research and education costs from grant, endowment, and tuition income and is content to break even—not have any dollars left over and not owe anyone money at the end of the year. Governments do not have equity. Their balance sheets do not follow the same sorts of rules for recording and valuing assets as public corporations. The objective of New York City is to make sure that various departments do not exceed their allotted budgets for the year, and their accounting reports are set up to gather that sort of information.

These three factors—market richness, complexity of transactions, and organizational form—provide a starting point for learning and understanding GAAP. They indicate the likely issues that GAAP apply to and their range of resolutions. The three factors do not and cannot provide definitive answers, but they do allow us to structure our study of accounting conventions. Your understanding of accounting conventions can be increased if you keep these three factors in mind.

Institutional Context

OBJECTIVE:
Learn to read actual financial statements by looking at excerpts from the reports of real companies.

GAAP do not dictate exact accounting treatments for all situations. They cannot. New transactions are constantly required for the exchange of novel items such as financial contracts, which are continually adapting to changing economic circumstances, advances in information technologies, and, most important for our purposes, changes in accounting conventions.

Even if GAAP did dictate exact treatments, we need to consider the human element in accounting. Were GAAP followed? What incentives were faced by the issuers of the accounting reports? Did these incentives influence their judgment at a conscious or unconscious level? For example, the total compensation of the chairman of the Chrysler Corporation depends on Chrysler's net income.[3]

[3]We do not intend to imply that Chrysler's financial statements were unduly influenced by Eaton because of his incentives. Executive bonuses tied to net income are commonplace, and any of literally thousands of other companies could be used as an illustration.

Chrysler:
Executive compensation

> Robert J. Eaton received an annual bonus, as reported in the Summary Compensation Table, based on Chrysler's performance with respect to consolidated net earnings.

These questions point to the importance of considering the institutional context within which accounting takes place. The institutional context shapes the consequences associated with accounting choices. For example, for a company's stock to be traded on the New York Stock Exchange (NYSE), the company must issue regular financial reports constructed in accordance with GAAP and audited by an independent, certified public accountant. Failure to comply with this requirement can cause a company's stock to be delisted (declared ineligible for trading on the exchange). Such stock exchange rules provide a powerful incentive for publicly traded corporations to adhere to GAAP. Exhibit 1.7 contains the independent auditor's report on Union Plaza's financial statements.

Exhibit 1.7
Union Plaza: Auditor's report

Independent Auditor's Report

The Stockholders and Board of Directors—Union Plaza Hotel and Casino, Inc.

We have audited the accompanying consolidated balance sheet of Union Plaza Hotel and Casino, Inc., and subsidiaries (a Nevada Corporation) as of December 31, 2001, and 2000, the related consolidated statements of loss, stockholders' equity and cash flows for the year then ended December 31, 2001, 2000, and 1999. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Union Plaza Hotel and Casino, Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of their operations and their cash flows for the year then ended December 31, 2001, 2000, and 1999 in conformity with accounting principles generally accepted in the United States of America.

Conway, Stuart & Woodbury CPAs
Las Vegas, Nevada.

The **Securities and Exchange Commission (SEC)** is the agency of the U.S. federal government that regulates the trading of public companies.

The **Financial Accounting Standards Board (FASB)** is the private-sector, not-for-profit organization that sets GAAP in the United States.

Who determines GAAP? The **Securities and Exchange Commission (SEC)** is an agency of the United States federal government that has authority to determine GAAP for public companies whose stock is traded across state lines. The SEC was established by Congress under the Securities Exchange Act of 1934. The SEC publishes Accounting Series Releases that contain its views of GAAP and the principles that must be followed in reports filed with the commission.

Although it has the formal authority to establish GAAP, the SEC prefers to allow private organizations to do so. Currently, the **Financial Accounting Standards Board (FASB),** a private, not-for-profit organization, sets GAAP in the United States. The FASB follows extensive due process rules. This process involves publicly declaring its agenda, seeking input from any interested parties at various points, promulgating "Exposure

Drafts" of proposed standards, and holding all its meetings in public view. Thus, the setting of accounting conventions is a decidedly social, as opposed to a logical or scientific, process.

The institutions affecting accounting go beyond the rule-making bodies. Independent auditors face civil liability when their certifications of financial reports contribute to losses by users of those reports. Substantial damages awarded in civil suits against auditors provide powerful incentives for auditors to insist that their clients follow GAAP.

Managers responsible for the accounting reports of public corporations often care about their reputations. The business press, financial analysts, and bond-rating agencies follow public companies' accounting reports and are constantly evaluating their disclosures. Public officials responsible for government finances are also scrutinized by the press and bond-rating agencies. Investors can divest themselves of ownership in companies whose public reports they do not trust, and citizens can vote at the ballot box and "with their feet" by abandoning jurisdictions that lose credibility. Not-for-profit organizations involved in financial scandals often find that contributions decline as a result. In 1991, the president of United Way of America resigned in light of alleged extravagant spending abuses. In 1992, many local chapters withheld payments to the parent organization and saw their own contributions plummet. Contributions to the United Way in Connecticut and New Jersey were $50.8 million in 1991–1992 but dropped to $41.6 million the following year, with many pledges being cancelled and some companies refusing to run fund drives.

Institutional context combines with economic concepts and accounting conventions to affect the information content of accounting reports. Context is especially important to keep in mind in a global economy, where accounting reports are generated using a variety of conventions and under a variety of circumstances. We will further develop economic concepts and provide greater detail about accounting conventions as we proceed through the remainder of this book. We also take many opportunities to discuss institutional arrangements. Our examples are drawn primarily from the United States, but it is important to underscore that wise use of accounting reports involves knowledge of the setting in which the reports were compiled. We offer the following guidelines for assessing institutional context:

- Determine how accounting conventions are set. Are there formal rule-making bodies like the FASB? Are the rules of another jurisdiction followed?
- Assess the auditing environment. Are audits by independent auditors required? What bodies police auditor behavior? Is there a strong accounting profession with incentives for self-policing?
- Assess the legal environment. Are there criminal penalties for white-collar crimes? Are the laws enforced? Are civil remedies available?
- Is the culture within which the reports were produced characterized by a preference for openness or secrecy? What are the traditions with respect to financial disclosure?
- For what purposes are the accounting reports compiled? Are there legal requirements or exchange regulations that mandate the accounting? Are the reports issued with the hope of raising resources through contributions, loans, or sale of the organization or some of its resources?

This list of factors, while not exhaustive, indicates the incentives and the opportunities for generating and taking advantage of "wiggle room" in the accounts.

Review Questions

1. Describe the process of setting accounting standards. What are the roles of all the parties you mention?

2. Think of an example, like the executive compensation example in the chapter, where incentives might exist to bias accounting numbers one way or another.

Conclusion

The remainder of this book is aimed at helping you grasp the fundamentals of economic concepts, accounting conventions, and institutional context required for a solid understanding of accounting. The economic concepts of financial value, wealth, and economic income are so basic to accounting that they deserve careful development. The effects of timing and uncertainty on assessments of financial value and techniques for handling them also merit our attention. Many accounting conventions must be introduced and explored, and some structure for organizing them should be offered. Too many specialized rules in various countries, across different industries, and for particular items make it impossible to memorize them all. We will continually refer to the dimensions of market richness, complexity of transactions, and organizational form to try to provide a reasonably coherent structure for a wide-ranging set of accounting conventions. Finally, delving into more specifics will give us the opportunity to present a richer picture of the institutional context of accounting.

The next chapter begins our look deeper into accounting by exploring the accounting balance sheet. We focus on the accounts of a for-profit corporation, which offers the most straightforward setting. The activities of organizations, the composition and nature of their assets, and the role of assets in the wealth creation process are examined. We also explore liabilities and the implementation of the identity

$$\text{ASSETS} = \text{LIABILITES} + \text{EQUITY}$$

in the construction of the balance sheet.

Key Terms

account *5*
accounting *3*
accounting conventions *4*
accounting valuation *16*
accounts payable *5*
accounts receivable *5*
accrued liabilities *5*
assets *5*
balance sheet *5*
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retained earnings *5*
revenues *6*
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sales revenue *6*
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shareholder equity *6*
wealth *13*