

Introduction to Accounting: The Language of Business

Lesson 1: Introduction to Financial Accounting Supplemental Textbook



Accounting defined

The American Accounting Association—one of the accounting organizations discussed later in this Introduction—defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information".¹ This information is primarily financial—stated in money terms. Accounting, then, is a measurement and communication process used to report on the activities of profit-seeking business organizations and not-for-profit organizations. As a measurement and communication process for business, accounting supplies information that permits informed judgments and decisions by users of the data.

The accounting process provides financial data for a broad range of individuals whose objectives in studying the data vary widely. Bank officials, for example, may study a company's financial statements to evaluate the company's ability to repay a loan. Prospective investors may compare accounting data from several companies to decide which company represents the best investment. Accounting also supplies management with significant financial data useful for decision making.

Reliable information is necessary before decision makers can make a sound decision involving the allocation of scarce resources. Accounting information is valuable because decision makers can use it to evaluate the financial consequences of various alternatives. Accountants eliminate the need for a crystal ball to estimate the future. They can reduce uncertainty by using professional judgment to quantify the future financial impact of taking action or delaying action.

Although accounting information plays a significant role in reducing uncertainty within the organization, it also provides financial data for persons outside the company. This information tells how management has discharged its responsibility for protecting and managing the company's resources. Stockholders have the right to know how a company is managing its investments. In fulfilling this obligation, accountants prepare financial statements such as an income statement, a statement of retained earnings, a balance sheet, and a statement of cash flows. In addition, they prepare tax returns for federal and state governments, as well as fulfill other governmental filing requirements.

Accounting is often confused with bookkeeping. Bookkeeping is a mechanical process that records the routine economic activities of a business. Accounting includes bookkeeping but goes well beyond it in scope. Accountants analyze and interpret financial information, prepare financial statements, conduct audits, design accounting systems, prepare special business and financial studies, prepare forecasts and budgets, and provide tax services.

Specifically the accounting process consists of the following groups of functions (see Exhibit 1 below):

- Accountants observe many events (or activities) and identify and measure in financial terms (dollars) those events considered evidence of economic activity. (Often, these three functions are collectively referred to as analyze.) The purchase and sale of goods and services are economic events.
- Next, the economic events are recorded, classified into meaningful groups, and summarized.
- Accountants report on economic events (or business activity) by preparing financial statements and special reports. Often accountants interpret these statements and reports for various groups such as management,

¹ American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston, III., 1966), p. 1.

investors, and creditors. Interpretation may involve determining how the business is performing compared to prior years and other similar businesses.

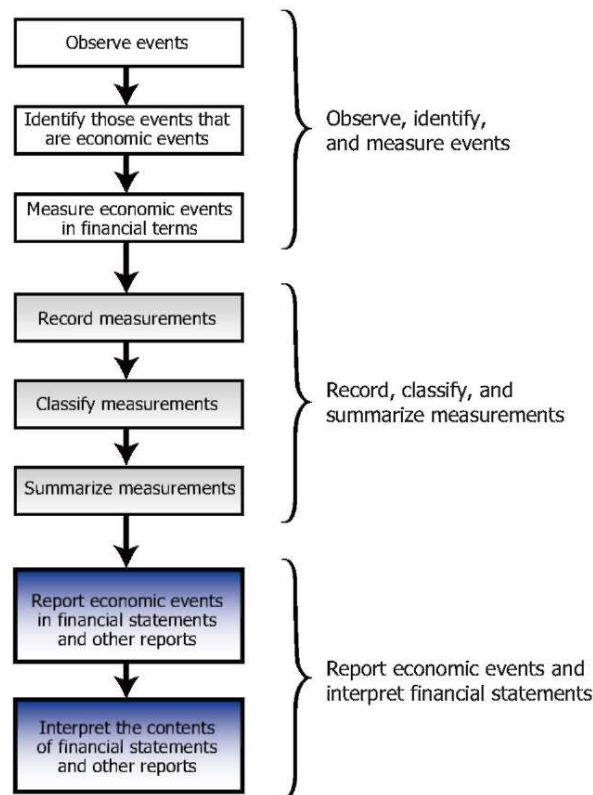


Exhibit 1: Functions performed by accountants.

Financial accounting versus managerial accounting

An accounting information system provides data to help decision makers both outside and inside the business. Decision makers outside the business are affected in some way by the performance of the business. Decision makers inside the business are responsible for the performance of the business. For this reason, accounting is divided into two categories: financial accounting for those outside and managerial accounting for those inside.

Financial accounting information appears in financial statements that are intended primarily for external use (although management also uses them for certain internal decisions). Stockholders and creditors are two of the outside parties who need financial accounting information. These outside parties decide on matters pertaining to the entire company, such as whether to increase or decrease their investment in a company or to extend credit to a company. Consequently, financial accounting information relates to the company as a whole, while managerial accounting focuses on the parts or segments of the company.

Management accountants in a company prepare the financial statements. Thus, management accountants must be knowledgeable concerning financial accounting and reporting. The financial statements are the representations of management, not the CPA firm that performs the audit.

The external users of accounting information fall into six groups; each has different interests in the company and wants answers to unique questions. The groups and some of their possible questions are:

- **Owners and prospective owners.** Has the company earned satisfactory income on its total investment? Should an investment be made in this company? Should the present investment be increased, decreased, or retained at the same level? Can the company install costly pollution control equipment and still be profitable?
- **Creditors and lenders.** Should a loan be granted to the company? Will the company be able to pay its debts as they become due?
- **Employees and their unions.** Does the company have the ability to pay increased wages? Is the company financially able to provide long-term employment for its workforce?
- **Customers.** Does the company offer useful products at fair prices? Will the company survive long enough to honor its product warranties?
- **Governmental units.** Is the company, such as a local public utility, charging a fair rate for its services?
- **General public.** Is the company providing useful products and gainful employment for citizens without causing serious environmental problems?

General-purpose financial statements provide much of the information needed by external users of financial accounting. These **financial statements** are formal reports providing information on a company's financial position, cash inflows and outflows, and the results of operations. Many companies publish these statements in annual reports. (See The Limited, Inc., annual report in the Annual report appendix.) The **annual report** also contains the independent auditor's opinion as to the fairness of the financial statements, as well as information about the company's activities, products, and plans.

Financial accounting information is historical in nature, reporting on what has happened in the past. To facilitate comparisons between companies, this information must conform to certain accounting standards or principles called **generally accepted accounting principles (GAAP)**. These generally accepted accounting principles for businesses or governmental organizations have developed through accounting practice or been established by an authoritative organization. We describe several of these authoritative organizations in the next major section of this Introduction.

Managerial accounting information is for internal use and provides special information for the managers of a company. The information managers use may range from broad, long-range planning data to detailed explanations of why actual costs varied from cost estimates. Managerial accounting information should:

- Relate to the part of the company for which the manager is responsible. For example, a production manager wants information on costs of production but not of advertising.
- Involve planning for the future. For instance, a budget would show financial plans for the coming year.
- Meet two tests: the accounting information must be useful (relevant) and must not cost more to gather and process than it is worth.

Managerial accounting generates information that managers can use to make sound decisions. The four major types of internal management decisions are:

- **Financial decisions**—deciding what amounts of capital (funds) are needed to run the business and whether to secure these funds from owners (stockholders) or creditors. In this sense, capital means money used by the company to purchase resources such as machinery and buildings and to pay expenses of conducting the business.
- **Resource allocation decisions**—deciding how the total capital of a company is to be invested, such as the amount to be invested in machinery.
- **Production decisions**—deciding what products are to be produced, by what means, and when.
- **Marketing decisions**—setting selling prices and advertising budgets; determining the location of a company's markets and how to reach them.

Development of financial accounting standards

Several organizations are influential in the establishment of generally accepted accounting principles (GAAP) for businesses or governmental organizations. These are the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Securities and Exchange Commission, the American Accounting Association, the Financial Executives Institute, and the Institute of Management Accountants. Each organization has contributed in a different way to the development of GAAP.

The American Institute of Certified Public Accountants (AICPA) is a professional organization of CPAs. Many of these CPAs are in public accounting practice. Until recent years, the AICPA was the dominant organization in the development of accounting standards. In a 20-year period ending in 1959, the AICPA Committee on Accounting Procedure issued 51 *Accounting Research Bulletins* recommending certain principles or practices. From 1959 through 1973, the committee's successor, the **Accounting Principles Board (APB)**, issued 31 numbered *Opinions* that CPAs generally are required to follow. Through its monthly magazine, the *Journal of Accountancy*, its research division, and its other divisions and committees, the AICPA continues to influence the development of accounting standards and practices. Two of its committees—the Accounting Standards Committee and the Auditing Standards Committee—are particularly influential in providing input to the Financial Accounting Standards Board (the current rule-making body) and to the Securities and Exchange Commission and other regulatory agencies.

In 1973, an independent, seven-member, full-time **Financial Accounting Standards Board (FASB)** replaced the Accounting Principles Board. The FASB has issued numerous *Statements of Financial Accounting Standards*. The old *Accounting Research Bulletins* and *Accounting Principles Board Opinions* are still effective unless specifically superseded by a Financial Accounting Standards Board Statement. The FASB is the *private sector* organization now responsible for the development of new financial accounting standards.

The Emerging Issues Task Force of the FASB interprets official pronouncements for general application by accounting practitioners. The conclusions of this task force must also be followed in filings with the Securities and Exchange Commission.

In 1984, the **Governmental Accounting Standards Board (GASB)** was established with a full-time chairperson and four part-time members. The GASB issues statements on accounting and financial reporting in the

governmental area. This organization is the *private sector* organization now responsible for the development of new governmental accounting concepts and standards. The GASB also has the authority to issue interpretations of these standards.

Created under the Securities and Exchange Act of 1934, the **Securities and Exchange Commission (SEC)** is a government agency that administers important acts dealing with the interstate sale of securities (stocks and bonds). The SEC has the authority to prescribe accounting and reporting practices for companies under its jurisdiction. This includes virtually every major US business corporation. Instead of exercising this power, the SEC has adopted a policy of working closely with the accounting profession, especially the FASB, in the development of accounting standards. The SEC indicates to the FASB the accounting topics it believes the FASB should address.

Consisting largely of accounting educators, the **American Accounting Association (AAA)** has sought to encourage research and study at a theoretical level into the concepts, standards, and principles of accounting. One of its quarterly magazines, *The Accounting Review*, carries many articles reporting on scholarly accounting research. Another quarterly journal, *Accounting Horizons*, reports on more practical matters directly related to accounting practice. A third journal, *Issues in Accounting Education*, contains articles relating to accounting education matters. Students may join the AAA as associate members by contacting the American Accounting Association, 5717 Bessie Drive, Sarasota, Florida 34233.

Accounting and its use in business decisions

A career as an entrepreneur

When today's college students are polled about their long-term career choice, a surprisingly large number respond that they wish to someday own and manage their own business. In fact, the aspiration to start a business, to be an entrepreneur, is nearly universal. It is widely acknowledged that a degree in accounting offers many advantages to a would-be entrepreneur. In fact, if you ask owners of small businesses which skill they wish they had more expertise in, they will very frequently reply "accounting". No matter what the business may be, the owner and/or manager must be able to understand the accounting and financial consequences of business decisions.

Most successful entrepreneurs have learned that it takes a lot more than a great marketing idea or product innovation to make a successful business. There are many steps involved before an idea becomes a successful and rewarding business. Entrepreneurs must be able to raise capital, either from banks or investors. Once a business has been launched, the entrepreneur must be a manager—a manager of people, inventory, facilities, customer relationships, and relationships with the very banks and investors that provided the capital. Business owners quickly learn that in order to survive they need to be well-rounded, savvy individuals who can successfully manage these diverse relationships. An accounting education is ideal for providing this versatile background.

In addition to providing a good foundation for entrepreneurship in any business, an accounting degree offers other ways of building your own business. For example, a large percentage of public accountants work as sole proprietors—building and managing their own professional practice. This can be a very rewarding career, working closely with individuals and small businesses. One advantage of this career is that you can establish your practice in virtually any location ranging from large cities to rural settings.

The introduction to this text provided a background for your study of accounting. Now you are ready to learn about the forms of business organizations and the types of business activities they perform. This chapter presents the financial statements used by businesses. These financial statements show the results of decisions made by management. Investors, creditors, and managers use these statements in evaluating management's past decisions and as a basis for making future decisions.

In this chapter, you also study the accounting process (or accounting cycle) that accountants use to prepare those financial statements. This accounting process uses financial data such as the records of sales made to customers and purchases made from suppliers. In a systematic manner, accountants analyze, record, classify, summarize, and finally report these data in the financial statements of businesses. As you study this chapter, you will begin to understand the unique, systematic nature of accounting—the language of business.

Forms of business organizations

Accountants frequently refer to a business organization as an **accounting entity** or a **business entity**. A business entity is any business organization, such as a hardware store or grocery store, that exists as an economic unit. For accounting purposes, each business organization or **entity** has an existence separate from its owner(s),

creditors, employees, customers, and other businesses.² This separate existence of the business organization is known as the **business entity concept**. Thus, in the accounting records of the business entity, the activities of each business should be kept separate from the activities of other businesses and from the personal financial activities of the owner(s).

Assume, for example, that you own two businesses, a physical fitness center and a horse stable. According to the business entity concept, you would consider each business as an independent business unit. Thus, you would normally keep separate accounting records for each business. Now assume your physical fitness center is unprofitable because you are not charging enough for the use of your exercise equipment. You can determine this fact because you are treating your physical fitness center and horse stable as two separate business entities. You must also keep your personal financial activities separate from your two businesses. Therefore, you cannot include the car you drive only for personal use as a business activity of your physical fitness center or your horse stable. However, the use of your truck to pick up feed for your horse stable is a business activity of your horse stable.

As you will see shortly, the business entity concept applies to the three forms of businesses—single proprietorships, partnerships, and corporations. Thus, for accounting purposes, all three business forms are separate from other business entities and from their owner(s). Since most large businesses are corporations, we use the corporate approach in this text and include only a brief discussion of single proprietorships and partnerships.

A **single proprietorship** is an unincorporated business owned by an individual and often managed by that same person. Single proprietors include physicians, lawyers, electricians, and other people in business for themselves. Many small service businesses and retail establishments are also single proprietorships. No legal formalities are necessary to organize such businesses, and usually business operations can begin with only a limited investment.

In a single proprietorship, the owner is solely responsible for all debts of the business. For accounting purposes, however, the business is a separate entity from the owner. Thus, single proprietors must keep the financial activities of the business, such as the receipt of fees from selling services to the public, separate from their personal financial activities. For example, owners of single proprietorships should not enter the cost of personal houses or car payments in the financial records of their businesses.

A **partnership** is an unincorporated business owned by two or more persons associated as partners. Often the same persons who own the business also manage the business. Many small retail establishments and professional practices, such as dentists, physicians, attorneys, and many CPA firms, are partnerships.

A partnership begins with a verbal or written agreement. A written agreement is preferable because it provides a permanent record of the terms of the partnership. These terms include the initial investment of each partner, the duties of each partner, the means of dividing profits or losses between the partners each year, and the settlement after the death or withdrawal of a partner. Each partner may be held liable for all the debts of the partnership and for the actions of each partner within the scope of the business. However, as with the single proprietorship, for accounting purposes, the partnership is a separate business entity.

2 When first studying any discipline, students encounter new terms. Usually these terms are set in bold. The boldface color terms are also listed and defined at the end of each chapter (see Key terms).

A **corporation** is a business incorporated under the laws of a state and owned by a few stockholders or thousands of stockholders. Almost all large businesses and many small businesses are incorporated.

The corporation is unique in that it is a separate legal business entity. The owners of the corporation are **stockholders**, or **shareholders**. They buy shares of stock, which are units of ownership, in the corporation. Should the corporation fail, the owners would only lose the amount they paid for their stock. The corporate form of business protects the personal assets of the owners from the creditors of the corporation.³

Stockholders do not directly manage the corporation. They elect a board of directors to represent their interests. The board of directors selects the officers of the corporation, such as the president and vice presidents, who manage the corporation for the stockholders.

Accounting is necessary for all three forms of business organizations, and each company must follow generally accepted accounting principles (GAAP). Since corporations have such an important impact on our economy, we use them in this text to illustrate basic accounting principles and concepts.

An accounting perspective:

Business insight

Although corporations constitute about 17 per cent of all business organizations, they account for almost 90 per cent of all sales volume. Single proprietorships constitute about 75 per cent of all business organizations but account for less than 10 per cent of sales volume.

Types of activities performed by business organizations

The forms of business entities discussed in the previous section are classified according to the type of ownership of the business entity. Business entities can also be grouped by the type of business activities they perform—service companies, merchandising companies, and manufacturing companies. Any of these activities can be performed by companies using any of the three forms of business organizations.

- **Service companies** perform services for a fee. This group includes accounting firms, law firms, and dry cleaning establishments. The early chapters of this text describe accounting for service companies.
- **Merchandising companies** purchase goods that are ready for sale and then sell them to customers. Merchandising companies include auto dealerships, clothing stores, and supermarkets. We begin the description of accounting for merchandising companies in Chapter 6.
- **Manufacturing companies** buy materials, convert them into products, and then sell the products to other companies or to the final consumers. Manufacturing companies include steel mills, auto manufacturers, and clothing manufacturers.

3 When individuals seek a bank loan to finance the formation of a small corporation, the bank often requires those individuals to sign documents making them personally responsible for repaying the loan if the corporation cannot pay. In this instance, the individuals can lose their original investments plus the amount of the loan they are obligated to repay.

All of these companies produce financial statements as the final end product of their accounting process. These financial statements provide relevant financial information both to those inside the company—management—and to those outside the company—creditors, stockholders, and other interested parties. The next section introduces four common financial statements—the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows.

Stockholders' equity: Classes of capital stock

The accountant as a corporate treasurer

Most people think of the stock market as a place to buy and sell stock. However, few people give much thought to the other side of this transaction. The original purpose of the stock market is to allow corporations to raise the money needed to expand into new markets, invent new products, open new stores, and create new jobs. The initial public issuance of stock (i.e. going public) is one of the most significant milestones in the life of a public company.

For most individual investors, trading is done by stockbrokers. Who handles the stock transactions within a company? The treasurer or the person that performs the treasury functions is this person. This role requires someone with a strong background in accounting and finance.

When a company decides to issue bonds or additional shares of stock, the treasurer is the person responsible for executing the transaction at the lowest cost to the entity. The treasurer works closely with investment bankers and lawyers to get the stocks or bonds marketed and issued in accordance with state and federal laws. When a company issues stock for the first time (initial public offering, or IPO), the task requires a thorough review of the financial position of the company and the public disclosure of this information for perhaps the first time. The treasurer/accountant must prepare what is called a prospectus. Among other things, the prospectus includes financial accounting information that is used in setting the price of the IPO.

The treasurer maintains custody of, or has access to, stocks owned by an entity and stock that is under the control of the entity. The treasurer also plays a pivotal role in the distribution of cash and stock dividends. The primary function of this position is controlling the cash inflows and outflows of the entity. A career as a corporate treasurer can involve the oversight of billions of dollars of stock, and the individual can earn a six-figure salary.

In this chapter, you study the corporate form of business organization in greater detail than in preceding chapters. Although corporations are fewer in number than single proprietorships and partnerships, corporations possess the bulk of our business capital and currently supply us with most of our goods and services.

This chapter discusses the advantages and disadvantages of the corporation, how to form and direct a corporation, and some of the unique situations encountered in accounting for and reporting on the different classes of capital stock. It is written from a US perspective, so you should be aware that laws and common practices may be different in other countries.

The corporation

A **corporation** is an entity recognized by law as possessing an existence separate and distinct from its owners; that is, it is a separate legal entity. Endowed with many of the rights and obligations possessed by a person, a corporation can enter into contracts in its own name; buy, sell, or hold property; borrow money; hire and fire employees; and sue and be sued.

Corporations have a remarkable ability to obtain the huge amounts of capital necessary for large-scale business operations. Corporations acquire their capital by issuing **shares of stock**; these are the units into which

corporations divide their ownership. Investors buy shares of stock in a corporation for two basic reasons. First, investors expect the value of their shares to increase over time so that the stock may be sold in the future at a profit. Second, while investors hold stock, they expect the corporation to pay them dividends (usually in cash) in return for using their money. Chapter 13 discusses the various kinds of dividends and their accounting treatment.

Advantages of the corporate form of business

Corporations have many advantages over single proprietorships and partnerships. The major advantages a corporation has over a single proprietorship are the same advantages a partnership has over a single proprietorship. Although corporations have more owners than partnerships, both have a broader base for investment, risk, responsibilities, and talent than do single proprietorships. Since corporations are more comparable to partnerships than to single proprietorships, the following discussion of advantages contrasts the partnership with the corporation.

- **Easy transfer of ownership.** In a partnership, a partner cannot transfer ownership in the business to another person if the other partners do not want the new person involved in the partnership. In a publicly held (owned by many stockholders) corporation, shares of stock are traded on a stock exchange between unknown parties; one owner usually cannot dictate to whom another owner can or cannot sell shares.

- **Limited liability.** Each partner in a partnership is personally responsible for all the debts of the business. In a corporation, the stockholders are not personally responsible for its debts; the maximum amount a stockholder can lose is the amount of his or her investment. However, when a small, closely held corporation (owned by only a few stockholders) borrows money, banks and lending institutions often require an officer of the small corporation to sign the loan agreement. Then, the officer has to repay the loan if the corporation does not.

- **Continuous existence of the entity.** In a partnership, many circumstances, such as the death of a partner, can terminate the business entity. These same circumstances have no effect on a corporation because it is a legal entity, separate and distinct from its owners.

- **Easy capital generation.** The easy transfer of ownership and the limited liability of stockholders are attractive features to potential investors. Thus, it is relatively easy for a corporation to raise capital by issuing shares of stock to many investors. Corporations with thousands of stockholders are not uncommon.

- **Professional management.** Generally, the partners in a partnership are also the managers of that business, regardless of whether they have the necessary expertise to manage a business. In a publicly held corporation, most of the owners (stockholders) do not participate in the day-to-day operations and management of the entity. They hire professionals to run the business on a daily basis.

- **Separation of owners and entity.** Since the corporation is a separate legal entity, the owners do not have the power to bind the corporation to business contracts. This feature eliminates the potential problem of mutual agency that exists between partners in a partnership. In a corporation, one stockholder cannot jeopardize other stockholders through poor decision making.

The corporate form of business has the following disadvantages:

- **Double taxation.** Because a corporation is a separate legal entity, its net income is subject to double taxation. The corporation pays a tax on its income, and stockholders pay a tax on corporate income received as dividends.

- **Government regulation.** Because corporations are created by law, they are subject to greater regulation and control than single proprietorships and partnerships.

- **Entrenched, inefficient management.** A corporation may be burdened with an inefficient management that remains in control by using corporate funds to solicit the needed stockholder votes to back its positions. Stockholders scattered across the country, who individually own only small portions of a corporation's stock, find it difficult to organize and oppose existing management.

- **Limited ability to raise creditor capital.** The limited liability of stockholders makes a corporation an attractive means for accumulating stockholder capital. At the same time, this limited liability feature restrains the amount of creditor capital a corporation can amass because creditors cannot look to stockholders to pay the debts of a corporation. Thus, beyond a certain point, creditors do not lend some corporations money without the personal guarantee of a stockholder or officer of the corporation to repay the loan if the corporation does not.

Stockholders Stockholders do not have the right to participate actively in the management of the business unless they serve as directors and/or officers. However, stockholders do have certain basic rights, including the right to (1) dispose of their shares, (2) buy additional newly issued shares in a proportion equal to the percentage of shares they already own (called the **preemptive right**), (3) share in dividends when declared, (4) share in assets in case of liquidation, and (5) participate in management indirectly by voting at the stockholders' meeting.

The preemptive right allows stockholders to maintain their percentage of ownership in a corporation when additional shares are issued. For example, assume Joe Thornton owns 10 per cent of the outstanding shares of Corporation X. When Corporation X decides to issue 1,000 additional shares of stock, Joe Thornton has the right to buy 100 (10 per cent) of the new shares. Should he decide to do so, he maintains his 10 per cent interest in the corporation. If he does not wish to exercise his preemptive right, the corporation may sell the shares to others.⁴

⁴ Some corporations have eliminated the preemptive right because the preemptive right makes it difficult to issue large blocks of stock to the stockholders of another corporation to acquire that corporation.

Illustration 12.1 Typical Corporation's Organization Chart

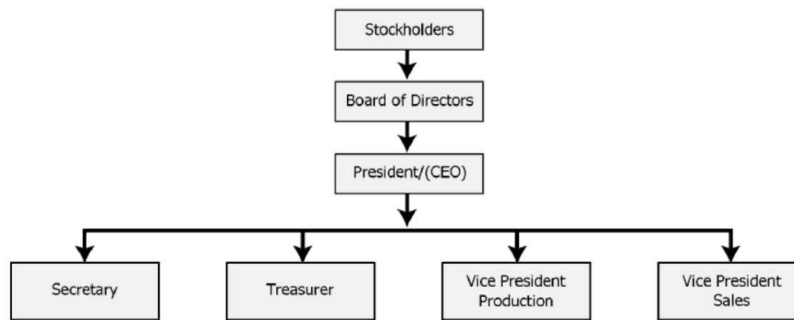


Exhibit 2: Typical corporation's organization chart

Normally, companies hold stockholders' meetings annually. At the annual stockholders' meeting, stockholders indirectly share in management by voting on such issues as changing the charter, increasing the number of authorized shares of stock to be issued, approving pension plans, selecting the independent auditor, and other related matters.

At stockholders' meetings, each stockholder is entitled to one vote for each share of voting stock held. Stockholders who do not personally attend the stockholders' meeting may vote by proxy. A **proxy** is a legal document signed by a stockholder, giving a designated person the authority to vote the stockholder's shares at a stockholders' meeting.

Board of directors Elected by the stockholders, the **board of directors** is primarily responsible for formulating policies for the corporation. The board appoints administrative officers and delegates to them the execution of the policies established by the board. The board's more specific duties include: (1) authorizing contracts, (2) declaring dividends, (3) establishing executive salaries, and (4) granting authorization to borrow money. The decisions of the board are recorded in the minutes of its meetings. The minutes are an important source of information to an independent auditor, since they may serve as notice to record transactions (such as a dividend declaration) or to identify certain future transactions (such as a large loan).

Corporate officers A corporation's bylaws usually specify the titles and duties of the officers of a corporation. The number of officers and their exact titles vary from corporation to corporation, but most have a president, several vice presidents, a secretary, a treasurer, and a controller.

The president is the chief executive officer (CEO) of the corporation. He or she is empowered by the bylaws to hire all necessary employees except those appointed by the board of directors.

Most corporations have more than one vice president. Each vice president is responsible for one particular corporate operation, such as sales, engineering, or production. The corporate secretary maintains the official records of the company and records the proceedings of meetings of stockholders and directors. The treasurer is accountable for corporate funds and may supervise the accounting function within the company. A controller carries out the accounting function. The controller usually reports to the treasurer of the corporation.

Documents, books, and records relating to capital stock

Capital stock consists of transferable units of ownership in a corporation. Each unit of ownership is called a share of stock. Typically, traders sell between 100 and 400 million shares of corporate capital stock every business day on stock exchanges, such as the New York Stock Exchange and the American Stock Exchange, and on the over-the-counter market. These sales (or trades) seldom involve the corporation issuing the stock as a party to the exchange. Existing stockholders sell their shares to other individual or institutional investors. The physical transfer of the stock certificates follows these trades.

A **stock certificate** is a printed or engraved document serving as evidence that the holder owns a certain number of shares of capital stock. When selling shares of stock, the stockholder signs over the stock certificate to the new owner, who presents it to the issuing corporation. When the old certificate arrives, the issuing corporation cancels the certificate and attaches it to its corresponding stub in the stock certificate book. The issuer prepares a new certificate for the new owner. To determine the number of shares of stock outstanding at any time, the issuer sums the shares shown on the open stubs (stubs without certificates attached) in the stock certificate book.

Among the more important records maintained by a corporation is the stockholders' ledger. The **stockholders' ledger** contains a group of subsidiary accounts showing the number of shares of stock currently held by each stockholder. Since the ledger contains an account for each stockholder, in a large corporation this ledger may have more than a million individual accounts. Each stockholder's account shows the number of shares currently or previously owned, their certificate numbers, and the dates on which shares were acquired or sold. Entries are made in the number of shares rather than in dollars.

The stockholders' ledger and the stock certificate book contain the same information, but the stockholders' ledger summarizes it alphabetically by stockholder. Since a stockholder may own a dozen or more certificates, each representing a number of shares, this summary enables a corporation to (1) determine the number of shares a stockholder is entitled to vote at a stockholders' meeting and (2) prepare one dividend check per stockholder rather than one per stock certificate.

Many large corporations with actively traded shares turn the task of maintaining reliable stock records over to an outside stock-transfer agent and a stock registrar. The **stock-transfer agent**, usually a bank or trust company, transfers stock between buyers and sellers for a corporation. The stock-transfer agent cancels the certificates covering shares sold, issues new stock certificates, and makes appropriate entries in the stockholders' ledger. It sends new certificates to the **stock registrar**, typically another bank, that maintains separate records of the shares outstanding. This control system makes it difficult for a corporate employee to issue stock certificates fraudulently and steal the proceeds.

The **minutes book**, kept by the secretary of the corporation, is (1) a record book of the actions taken at stockholders' and board of directors' meetings and (2) the written authorization for many actions taken by corporate officers. Remember that all actions taken by the board of directors and the stockholders must be in accordance with the provisions in the corporate charter and the bylaws. The minutes book contains a variety of data, including:

- A copy of the corporate charter.

- A copy of the bylaws.
- Dividends declared by the board of directors.
- Authorization for the acquisition of major assets.
- Authorization for borrowing.
- Authorization for increases or decreases in capital stock.

Long-term financing: Bonds

The accountant's role in financial institutions

Companies that require funds to maintain existing operations and expand new operations frequently do not have the necessary cash available within the company. Therefore, these companies are required to obtain long-term financing from banks and other financial institutions. The operations of financial institutions are unique from those of the typical manufacturing or service company. As a result, the accounting measurement and disclosure practices followed by financial institutions can be quite different from those followed in other industries. In addition to the more traditional careers in accounting (auditing, professional services, financial reporting, cost accounting, and taxation), accounting majors with interests in finance may pursue a career in financial institutions.

Accountants in this industry commonly deal with issues related to marketable securities, derivatives, hedging, sale of receivables, foreign currency exchanges, and loan loss provisions and impairments. In addition, accountants in this area are being called upon to play an increasing role in the strategic operations of the financial institution. Not only are accountants needed to account for the institution's transactions, but they are being asked to recommend new opportunities for growth and to advise on financial risk as well. Some of these new areas include issues related to asset/liability management, interest rate risk, present value measurements, capital structure, and key ratio analysis.

Accountants also play a key role in one of the most important decisions of a financial institution—the decision of whether to lend money to a prospective borrower. The decision to lend money hinges on the ability of the prospective borrower to pay interest and repay debt. Since accountants have been trained in financial statement preparation and interpretation, accountants are some of the most sought after professionals for understanding the financial position and risk of a prospective borrower.

In previous chapters, you learned that corporations obtain cash for recurring business operations from stock issuances, profitable operations, and short-term borrowing (current liabilities). However, when situations arise that require large amounts of cash, such as the purchase of a building, corporations also raise cash from long-term borrowing, that is, by issuing bonds. The issuing of bonds results in a Bonds Payable account.

Managerial accounting concepts/job costing

Learning objectives

After studying this chapter, you should be able to:

- Compare and contrast managerial accounting and financial accounting.
- Describe the basic components of a products cost.
- Explain the difference between product costs and period costs.
- Compare financial reporting by a merchandiser to that of a manufacturer and prepare a statement of cost of goods manufactured, an income statement, and a balance sheet for a manufacturer.
- Explain the pattern of cost flows for a company.
- Compare and contrast different production methods and accounting systems.
- Describe job cost flows and determine the cost of jobs.
- Explain how and why predetermined overhead rates are computed.
- Describe the differences in net income under absorption costing and variable costing (appendix).

Compare managerial accounting with financial accounting

Whereas financial accounting provides financial information primarily for external use, **managerial accounting** information is for internal use. By reporting on the financial activities of the organization, financial accounting provides information needed by investors and creditors.

Most managerial decisions require more detailed information than that provided by external financial reports. For instance, in their external financial statements, large corporations such as General Electric Company show single amounts on their balance sheets for inventory. However, managers need more detailed information about the cost of each of several hundred products.

We show the fundamental differences between managerial and financial accounting in the chart.

Financial accounting

Users

External users of information – usually shareholders, financial analysts, and creditors

Compliance with generally accepted

Accounting Principles

Must comply with generally accepted accounting principles.

Future versus past

Uses historical data.

Detail presented

Presents summary data, costs, revenues, and profits.

Managerial accounting

Internal users of information – usually managers.

Need not comply with generally accepted accounting principles. Internal cost/benefit evaluation determines how much information is enough.

May use estimates of the future for budgeting and decision making.

More detailed data are presented about product.

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