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ACCOUNTING PRINCIPLES

2

THE NAVIGATOR ✓

- Understand *Concepts for Review* ❑
- Read *Feature Story* ❑
- Scan *Study Objectives* ❑
- Read *Preview* ❑
- Read text and answer *Before You Go On* *p.* 40 ❑ *p.* 47 ❑ *p.* 64 ❑
- Work *Demonstration Problems* ❑
- Review *Summary of Study Objectives* ❑
- Complete *Assignments* ❑

CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

a. The two organizations primarily responsible for setting accounting standards. (Ch. 1, pp. 8–9)

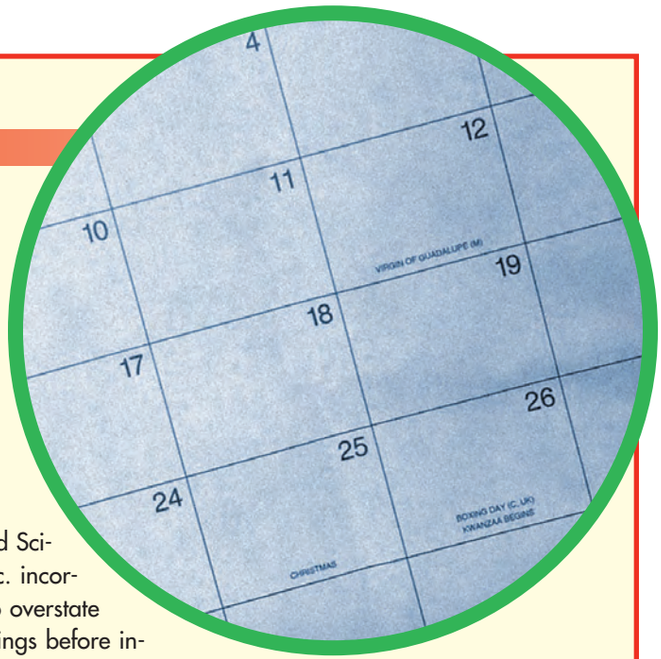
b. The monetary unit assumption and the economic entity assumption. (Ch. 1, pp. 9–10)

c. The cost principle. (Ch. 1, p. 9)

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FEATURE STORY



Certainly Worth Investigating!

It is often difficult to determine in what period some revenues and expenses should be reported. There are rules that give guidance, but occasionally these rules are overlooked, misinterpreted, or even intentionally ignored. Consider the following examples.

• **Reliant Energy**, a provider of electricity and energy services to wholesale and retail markets, restated their revenues down by 10 percent for the first quarter of 2001. This came one week after the company admitted to using bogus trades to overstate revenues.

• **Merck**, one of the giants in pharmaceuticals, withdrew an initial public offering of Medco Health Solutions, its pharmacy benefits management unit, at a total price of about $46 million when it found out that Medco booked $14 billion in revenues that it never collected.

• **Adelphia Communications**, once a leading cable TV firm, booked marketing support payments it received from Motorola Inc. and Scientific-Atlanta Inc. incorrectly in order to overstate its EBITDA (earnings before interest, tax, depreciation, and amortization) by almost $95 million.

Often in cases such as these, the company's shareholders sue the company because of the decline in the stock price due to the disclosure of the misinformation. In light of this eventuality, why might management want to report revenues or expenses in the wrong period? Company managers are under intense pressure to report higher earnings every year. If actual performance falls short of expectations, management might be tempted to bend the rules.

One analyst suggests that investors and auditors should be suspicious of sharp increases in monthly sales at the end of each quarter or big jumps in fourth-quarter sales. Such events don't always mean management is cheating, but they are certainly worth investigating.

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STUDY OBJECTIVES

After studying this chapter, you should be able to

1. Explain the meaning of generally accepted accounting principles and identify the key items of the conceptual framework.
2. Describe the basic objectives of financial reporting.
3. Discuss the qualitative characteristics of accounting information and elements of financial statements.
4. Identify the basic assumptions used by accountants.
5. Identify the basic principles of accounting.
6. Identify the two constraints in accounting.
7. Understand and analyze classified financial statements.
8. Explain the accounting principles used in international operations.
9. Identify the various systems of accounting procedures used in the hospitality industry.
10. Understand accounting and financial management in a hotel.
11. Understand accounting and financial management in a foodservice operation and a club.

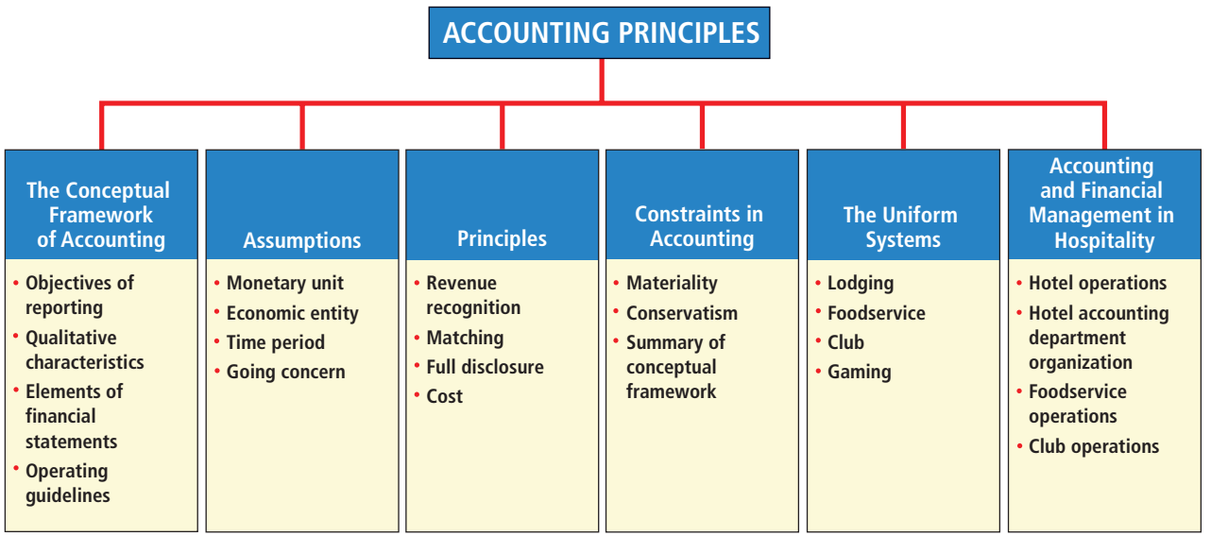
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PREVIEW OF CHAPTER 2

As indicated in the Feature Story, it is important that general guidelines be available to resolve accounting issues. Without these basic guidelines, each enterprise would have to develop its own set of accounting practices. If this happened, we would have to become familiar with every company's peculiar accounting and reporting rules in order to understand their financial statements. It would be difficult, if not impossible, to compare the financial statements of different companies. This chapter explores the basic accounting principles used in developing specific accounting guidelines. The Uniform Systems of Accounts used in hospitality accounting reporting is also discussed.

The content and organization of Chapter 2 are as follows:



THE NAVIGATOR

THE CONCEPTUAL FRAMEWORK OF ACCOUNTING

STUDY OBJECTIVE 1

Explain the meaning of generally accepted accounting principles and identify the key items of the conceptual framework.

What you have learned up to this point in the book is a process that leads to the preparation of financial reports about a company. These are the company's financial statements. This area of accounting is called **financial accounting**. The accounting profession has established a set of standards and rules that are recognized as a general guide for financial reporting. This recognized set of standards is called **generally accepted accounting principles (GAAP)**. *Generally accepted* means that these principles must have "substantial authoritative support." Such support usually comes from two standard-setting bodies: the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).[1]

[1]The SEC is an agency of the U.S. government that was established in 1933 to administer laws and regulations relating to the exchange of securities and the publication of financial information by U.S. businesses. The agency has the authority to mandate generally accepted accounting principles for companies under its jurisdiction. However, throughout its history, the SEC has been willing to accept the principles set forth by the FASB and similar bodies.

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Since the early 1970s the business and governmental communities have given the FASB the responsibility for developing accounting principles in this country. This is an ongoing process; accounting principles change to reflect changes in the business environment and in the needs of users of accounting information.

Prior to the establishment of the FASB, accounting principles were developed on a problem-by-problem basis. Rule-making bodies developed accounting rules and methods to solve specific problems. Critics charged that the problem-by-problem approach led over time to inconsistent rules and practices. No clearly developed conceptual framework of accounting existed to refer to in solving new problems.

In response to these criticisms, the FASB developed a **conceptual framework**. It serves as the basis for resolving accounting and reporting problems. The FASB spent considerable time and effort on this project. The Board views its conceptual framework as ". . . a constitution, a coherent system of interrelated objectives and fundamentals."[2]

The FASB's conceptual framework consists of four items:

1. Objectives of financial reporting
2. Qualitative characteristics of accounting information
3. Elements of financial statements
4. Operating guidelines (assumptions, principles, and constraints)

We will discuss these items on the following pages.

HELPFUL HINT

Accounting principles are affected by economic and political conditions that change over time. As a result, accounting principles are not cut into stone like the periodic table in chemistry or a formula in math.

ACCOUNTING IN ACTION *International Insight*

Different political and cultural influences affect the accounting that occurs in foreign countries. For example, in Sweden, accounting is considered an instrument to be used to shape fiscal policy. In Europe generally, more emphasis is given to social reporting (more information on employment statistics, health of workers, and so on) than in the United States. European labor organizations are strong and demand that type of information from management.



OBJECTIVES OF FINANCIAL REPORTING

STUDY OBJECTIVE 2

Describe the basic objectives of financial reporting.

The FASB began to work on the conceptual framework by looking at the objectives of financial reporting. Determining these objectives required answers to such basic questions as: Who uses financial statements? Why? What information do they need? How knowledgeable about business and accounting are financial statement users? How should financial information be reported so that it is best understood?

In answering these questions, the FASB concluded that financial reporting should have three objectives:

1. The information is useful to those making investment and credit decisions.
2. The financial reports are helpful in assessing future cash flows.
3. The economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims are clearly identified.

The FASB then undertook to describe the characteristics that make accounting information useful.

[2]"Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement," *FASB Discussion Memorandum* (Stamford, Conn.: 1976), p. 1.

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QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

STUDY OBJECTIVE 3

Discuss the qualitative characteristics of accounting information and elements of financial statements.

How does a company like the **Club Corporation of America** decide on the amount of financial information to disclose? In what format should its financial information be presented? How should assets, liabilities, revenues, and expenses be measured? The FASB concluded that the overriding criterion for such accounting choices is **decision usefulness**. The accounting practice selected should be the one that generates the most useful financial information for making a decision. To be useful, information should possess the following qualitative characteristics: relevance, reliability, comparability, and consistency.

Relevance

Accounting information has **relevance** if it makes a difference in a decision. Relevant information has either predictive or feedback value or both. **Predictive value** helps users forecast future events. For example, when **Four Seasons Hotels & Resorts** issues financial statements, the information in them is considered relevant because it provides a basis for predicting future earnings. **Feedback value** confirms or corrects prior expectations. When **Four Seasons** issues financial statements, it confirms or corrects prior expectations about the financial health of the company.

HELPFUL HINT
What makes accounting information relevant? Answer: Relevant accounting information provides feedback, serves as a basis for predictions, and is timely (current).

In addition, accounting information has relevance if it is **timely**. It must be available to decision makers before it loses its capacity to influence decisions. If **Four Seasons** reported its financial information only every five years, the information would be of limited use in decision making.

Reliability

Reliability of information means that the information is free of error and bias. In short, it can be depended on. To be reliable, accounting information must be **verifiable**: We must be able to prove that it is free of error and bias. It also must be a **faithful representation** of what it purports to be: It must be factual. If the **Felcor Lodging Trust** balance sheet reports assets of $8 billion when it had assets of $51 billion, then the statement is not a faithful representation. Finally, accounting information must be **neutral**: It cannot be selected, prepared, or presented to favor one set of interested users over another. To ensure reliability, certified public accountants audit financial statements.

HELPFUL HINT
What makes accounting information reliable? Answer: Reliable accounting information is free of error and bias, is factual, verifiable, and neutral.

Comparability

Accounting information about an enterprise is most useful when it can be compared with accounting information about other enterprises. **Comparability** results when different companies use the same accounting principles. For example, **Accor** and **Adam's Mark** use the cost principle in reporting plant assets on the balance sheet. Also, each company uses the revenue recognition and matching principles in determining its net income.

Conceptually, comparability should also extend to the methods used by companies in complying with an accounting principle. Accounting methods include the FIFO and LIFO methods of inventory costing, and various depreciation methods. At this point, comparability of methods is not required, even for companies in the same industry. Thus, **LaQuinta Inns and Suites** and **Choice Hotels International** may use different inventory costing and depreciation methods in their financial statements. The only accounting requirement is that each company **must disclose** the accounting methods used. From the disclosures, the external user can determine whether the financial information is comparable.

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Consistency

Consistency means that a company uses the same accounting principles and methods from year to year. If a company selects FIFO as the inventory costing method in the first year of operations, it is expected to use FIFO in succeeding years. When financial information has been reported on a consistent basis, the financial statements permit meaningful analysis of trends within a company.

A company *can* change to a new method of accounting. To do so, management must justify that the new method results in more meaningful financial information. In the year in which the change occurs, the change must be disclosed in the notes to the financial statements. Such disclosure makes users of the financial statements aware of the lack of consistency.

ACCOUNTING IN ACTION *Business Insight*

There is a classic story that professors often tell students about a company looking for an accountant. The company approached the first accountant and asked: "What do you believe our net income will be this year?" The accountant said, "Four million dollars." The company asked the second accountant the same question, and the answer was, "What would you like it to be?" Guess who got the job?

The reason we tell the story here is that, because accounting principles offer flexibility, it is important that a consistent treatment be provided from period to period. Otherwise it would be very difficult to interpret financial statements. Perhaps *no* alternative methods should be permitted in accounting. What do you think?

	Y.T.D	%	SEPT. 02
NUMBER OF ROOMS	86		86
THIS MTHS AVAI. OF ROOMS	8077		2224
ROOMS SOLD	4630		1298
PERCNT. OF OCCUPANCY	57.3%	57.3%	58.4%
NET AVERAGE ROOM RATE	85.73		82.03
REVENUE			
ROOMS	396,923	26.9%	106,470
F O O D	753,794	51.1%	196,152
BEVERAGES	62,743	4.3%	15,000
GIFT SHOP	23,045	1.6%	7,699
PUBLIC ROOM RENTALS	118,081	8.0%	34,103
AUDIO & VIDEO	40,604	2.8%	10,051
TELEPHONE	4,608		1,748
GARAGE	62,217		20,489
COPY, FAX	12,305		3,800
VALET, DECRTN, PIANO ETC	1,653		559
OTHER INCOME - TOTAL	80,783	5.5%	26,595
TOTAL NET INCOME	1,475,972	100.0%	396,070

The qualitative characteristics of accounting information are summarized in Illustration 2-1.

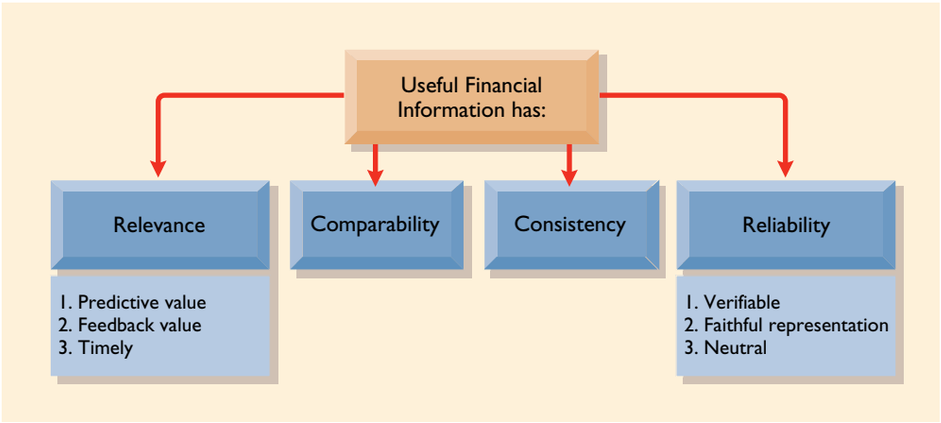


Illustration 2-1
Qualitative characteristics of accounting information

ELEMENTS OF FINANCIAL STATEMENTS

An important part of the accounting conceptual framework is a set of definitions that describe the basic terms used in accounting. The FASB refers to this set of definitions as the **elements of financial statements**. They include such terms as *assets*, *liabilities*, *equity*, *revenues*, and *expenses*.

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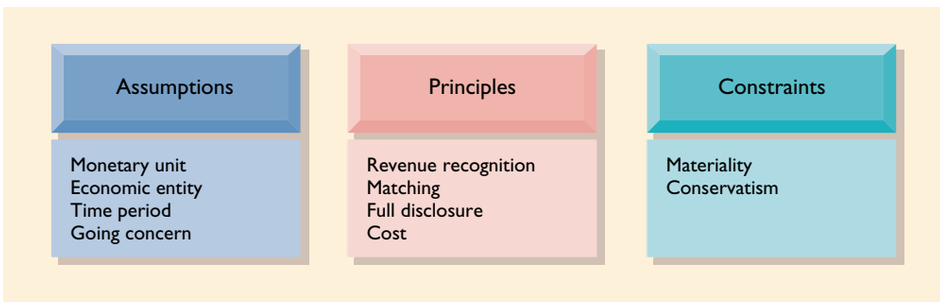
Because these elements are so important, it is crucial that they be precisely defined and universally applied. Finding the appropriate definition for many of these elements is not easy. For example, should the value of a company's employees be reported as an asset on a balance sheet? Should the death of the company's president be reported as a loss? A good set of definitions should provide answers to these types of questions. Because you have already encountered most of these definitions in earlier chapters, they are not repeated here.

OPERATING GUIDELINES

The objectives of financial reporting, the qualitative characteristics of accounting information, and the elements of financial statements are very broad. Because practicing accountants must solve practical problems, more detailed guidelines are needed. In its conceptual framework, the FASB recognized the need for operating guidelines. We classify these guidelines as assumptions, principles, and constraints. These guidelines are well established and accepted in accounting.

Assumptions provide a foundation for the accounting process. **Principles** are specific rules that indicate how economic events should be reported in the accounting process. **Constraints** on the accounting process allow for a relaxation of the principles under certain circumstances. Illustration 2-2 provides a roadmap of the operating guidelines of accounting. These guidelines (some of which you know from earlier chapters) are discussed in more detail in the following sections.

Illustration 2-2
The operating guidelines of accounting



BEFORE YOU GO ON...

REVIEW IT

1. What are generally accepted accounting principles?
2. What is stated about generally accepted accounting principles in the Report of Independent Public Accountants for **Hilton**? The answer to this question appears on page 73.
3. What are the basic objectives of financial information?
4. What are the qualitative characteristics that make accounting information useful? Identify two elements of the financial statements.

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STUDY OBJECTIVE 4
Identify the basic assumptions used by accountants.

ASSUMPTIONS

As noted above, assumptions provide a foundation for the accounting process. Below are definitions of four basic accounting assumptions.

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MONETARY UNIT ASSUMPTION

The **monetary unit assumption** states that only transaction data that can be expressed in terms of money be included in the accounting records. For example, the value of a company president is not reported in a company's financial records because it cannot be expressed easily in dollars.

An important corollary to the monetary unit assumption is the assumption that the unit of measure remains relatively constant over time. This point will be discussed in more detail later in this chapter.

ECONOMIC ENTITY ASSUMPTION

The **economic entity assumption** states that the activities of the entity be kept separate and distinct from the activities of the owners and of all other economic entities. For example, it is assumed that the activities of **Peabody Hotel Group** can be distinguished from those of other computer companies such as **Cendant**, **Forte Hotels**, and **John Q. Hammons Hotels**.

INTERNATIONAL NOTE

In an action that sent shock waves through the French business community, the CEO of Alcatel-Alsthom was taken into custody for an apparent violation of the economic entity assumption. Allegedly, the executive improperly used company funds to install an expensive security system in his home.

TIME PERIOD ASSUMPTION

The **time period assumption** states that the economic life of a business can be divided into artificial time periods. Thus, it is assumed that the activities of business enterprises such as **MeriStar Hotels and Resorts**, **Ameri Suites**, **Carlson Hospitality**, or any enterprise can be subdivided into months, quarters, or a year for meaningful financial reporting purposes.

GOING CONCERN ASSUMPTION

The **going concern assumption** assumes that the enterprise will continue in operation long enough to carry out its existing objectives. In spite of numerous business failures, companies have a fairly high continuance rate. It has proved useful to adopt a going concern assumption for accounting purposes.

The accounting implications of this assumption are critical. If a going concern assumption is not used, then plant assets should be stated at their liquidation value (selling price less cost of disposal)—not at their cost. In that case, depreciation and amortization of these assets would not be needed. Each period, these assets would simply be reported at their liquidation value. Also, without this assumption, the current–noncurrent classification of assets and liabilities would not matter. Labeling anything as long-term would be difficult to justify.

Acceptance of the going concern assumption gives credibility to the cost principle. Only when liquidation appears imminent is the going concern assumption inapplicable. In that case, assets would be better stated at liquidation value than at cost.

These basic accounting assumptions are illustrated graphically in Illustration 2-3 on the next page.

HELPFUL HINT

(1) Which accounting assumption assumes that an enterprise will remain in business long enough to recover the cost of its assets? (2) Which accounting assumption is justification for the cost principle?
Answers: (1) and (2) Going concern assumption.

PRINCIPLES

STUDY OBJECTIVE 5

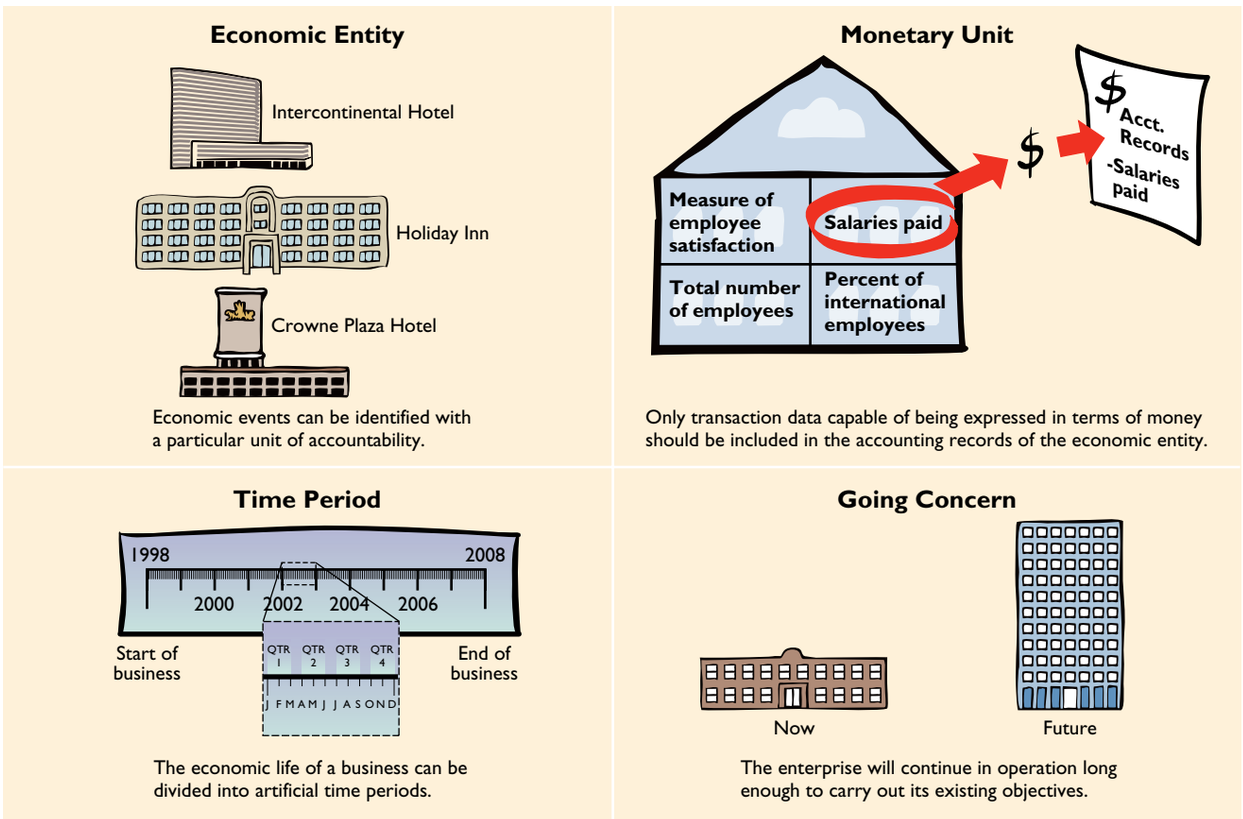
Identify the basic principles of accounting.

On the basis of the fundamental assumptions of accounting, the accounting profession has developed principles that dictate how economic events should be recorded and reported. In Chapter 1 we discussed the cost principle and we will also discuss the revenue recognition and matching principles in Chapter 4. Here we now examine a number of reporting issues related to these principles. In addition, we introduce another principle, the full disclosure principle.

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Illustration 2-3

Assumptions used in accounting



HELPFUL HINT

Revenue should be recognized in the accounting period in which it is earned. This may not be the period in which the related cash is received. In a retail establishment, the point of sale is often the critical point in the process of earning revenue.

REVENUE RECOGNITION PRINCIPLE

The **revenue recognition principle** dictates that revenue should be recognized in the accounting period in which it is earned. But applying this general principle in practice can be difficult. Some companies improperly recognize revenue on goods that have not been shipped to customers. Similarly, until recently, financial institutions immediately recorded a large portion of their loan fees as revenue rather than spreading those fees over the life of the loan.

When a sale is involved, revenue is recognized at the point of sale. This **sales basis** involves an exchange transaction between the seller and buyer. The sales price is an objective measure of the amount of revenue realized. However, two exceptions to the sales basis for revenue recognition have become generally accepted—the percentage-of-completion method and the installment method. These methods are left for more advanced courses.

MATCHING PRINCIPLE (EXPENSE RECOGNITION)

Expense recognition is traditionally tied to revenue recognition: "Let the expense follow the revenue." As you will learn in Chapter 4, this practice is referred to as the **matching principle**. It dictates that expenses be matched with revenues in the period in which efforts are made to generate revenues. Expenses are not recognized when cash is paid, or when the work is performed, or when the product is produced. Rather, they are recognized when the labor (service) or the product actually makes its contribution to revenue.

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But, it is sometimes difficult to determine the accounting period in which the expense contributed to revenues. Several approaches have therefore been devised for matching expenses and revenues on the income statement.

To understand these approaches, you need to understand the nature of expenses. Costs are the source of expenses. Costs that will generate revenues only in the current accounting period are expensed immediately. They are reported as **operating expenses** in the income statement. Examples include costs for advertising, sales salaries, and repairs. These expenses are often called **expired costs**.

Costs that will generate revenues in future accounting periods are recognized as assets. Examples include merchandise inventory, prepaid expenses, and plant assets. These costs represent **unexpired costs**. Unexpired costs become expenses in two ways:

1. **Cost of goods sold.** Costs carried as merchandise inventory become expenses when the inventory is sold. They are expensed as cost of goods sold in the period when the sale occurs. Thus, there is a direct matching of expenses with revenues.
2. **Operating expenses.** Other unexpired costs become operating expenses through use or consumption (as in the case of store supplies) or through the passage of time (as in the case of prepaid insurance). The costs of plant assets and other long-lived resources are expensed through rational and systematic allocation methods—periodic depreciation or amortization. Operating expenses contribute to the revenues for the period, but their association with revenues is less direct than for cost of goods sold.

These points about expense recognition are illustrated in Illustration 2-4.

HELPFUL HINT
Costs become expenses when they are charged against revenue.

ETHICS NOTE
Many appear to do it, but few like to discuss it: It's earnings management, and it's a clear violation of the revenue recognition and matching principles. Banks sometimes time the sale of investments or the expensing of bad debts to accomplish earnings objectives. Prominent companies have been accused of matching one-time gains with one-time charge-offs so that current-period earnings are not so high that they can't be surpassed next period.

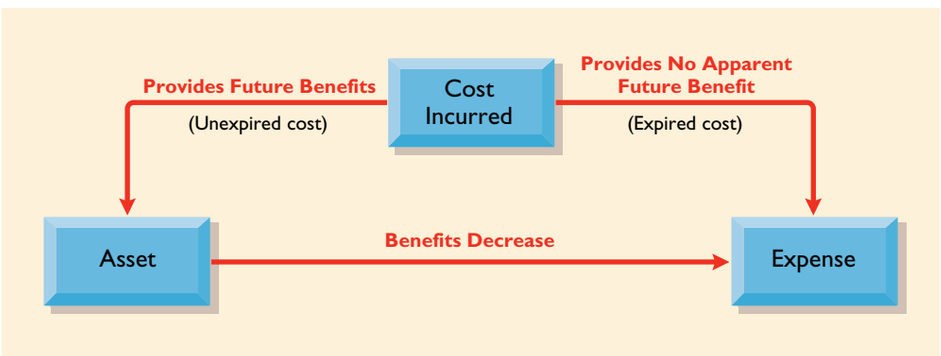


Illustration 2-4
Expense recognition pattern

ACCOUNTING IN ACTION *Business Insight*



Implementing expense recognition guidelines can be difficult. Consider, for example, **Harold's Club** (a gambling casino) in Reno, Nevada. How should it report expenses related to the payoff of its progressive slot machines? Progressive slot machines, which generally have no ceiling on their jackpots, provide a lucky winner with all the money that many losers had previously put in. Payoffs tend to be huge, but infrequent. At Harold's, the progressive slots pay off on average every 4½ months.

The basic accounting question is: Can Harold's deduct the millions of dollars sitting in its progressive slot machines from the revenue recognized at the end of the accounting period? One might argue that no, you cannot deduct the money until the "winning handle pull." However, a winning handle pull might not occur for many months or even years. Although an estimate would have to be used, the better answer is to match these costs with the revenue recognized, assuming that an average 4½ months' payout is well documented. Obviously, the matching principle can be difficult to apply in practice.

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FULL DISCLOSURE PRINCIPLE

The **full disclosure principle** requires that circumstances and events that make a difference to financial statement users be disclosed. For example, most accountants would agree that hospitality companies should disclose any liability suits pending against them. Interested parties would want to be made aware of this contingent loss. Similarly, it is generally agreed that companies should disclose the major provisions of employee pension plans and long-term lease contracts.

Compliance with the full disclosure principle occurs through the data in the financial statements and the information in the notes that accompany the statements. The first note in most cases is a **summary of significant accounting policies**. It includes, among others, the methods used for inventory costing, depreciation of plant assets, and amortization of intangible assets.

Deciding how much disclosure is enough can be difficult. Accountants could disclose every financial event that occurs and every contingency that exists. But the benefits of providing additional information in some cases may be less than the costs of doing so. Many companies complain of an accounting standards overload. They also object to requirements that force them to disclose confidential information. Determining where to draw the line on disclosure is not easy.

One thing is certain: financial statements were much simpler years ago. In 1930, **General Electric** had no notes to its financial statements. Today it has more than twenty pages of notes! Why this change? A major reason is that the objectives of financial statements have changed. In the past, information was generally presented on what the business had done. Today, the objectives of financial reporting are more future-oriented. The goal is to provide information that makes it possible to predict the amounts, timing, and uncertainty of future cash flows.



ACCOUNTING IN ACTION Business Insight

Some accountants are reconsidering the current means of financial reporting. They propose a database concept of financial reporting. In such a system, all the information from transactions would be stored in a computerized database to be accessed by various user groups. The main benefit of such a system is the ability to tailor the information requested to the needs of each user.

What makes this idea controversial? Discussion currently revolves around access and aggregation issues. Questions abound: "Who should be allowed to make inquiries of the system?" "What is the lowest/smallest level of information to be provided?" "Will such a system necessarily improve on the current means of disclosure?" Such questions must be answered before database financial accounting can be implemented on a large scale.

COST PRINCIPLE

The **cost principle** dictates that assets be recorded at their cost. Cost is used because it is both relevant and reliable. Cost is **relevant** because it represents the price paid, the assets sacrificed, or the commitment made at date of acquisition. Cost is **reliable** because it is objectively measurable, factual, and verifiable. It is the result of an exchange transaction. Cost is the basis used in preparing financial statements.

The relevance of the cost principle, however, has come under criticism. After acquisition, the argument goes, the cost of an asset is not equivalent to market value or current value. Also, as the purchasing power of the dollar changes, so does the meaning associated with the dollar used as the basis of measurement.

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Consider the classic story about the individual who went to sleep and woke up 10 years later. Hurrying to a telephone, he called his broker and asked what his formerly modest stock portfolio was worth. He was told that he was a multimillionaire. His **Starwood** stock was worth $5 million, and his **Hilton** stock was up to $10 million. Elated, he was about to inquire about his other holdings, when the telephone operator cut in with "Your time is up. Please deposit $100,000 for the next three minutes."[3]

Despite the inevitability of changing prices due to inflation, the accounting profession still follows the stable monetary unit assumption in preparing the primary financial statements. While admitting that some changes in prices do occur, the profession believes the unit of measure—the dollar—has remained sufficiently constant over time to provide meaningful financial information. *Sometimes, the disclosure of price-level adjusted data is in the form of supplemental information that accompanies the financial statements.*

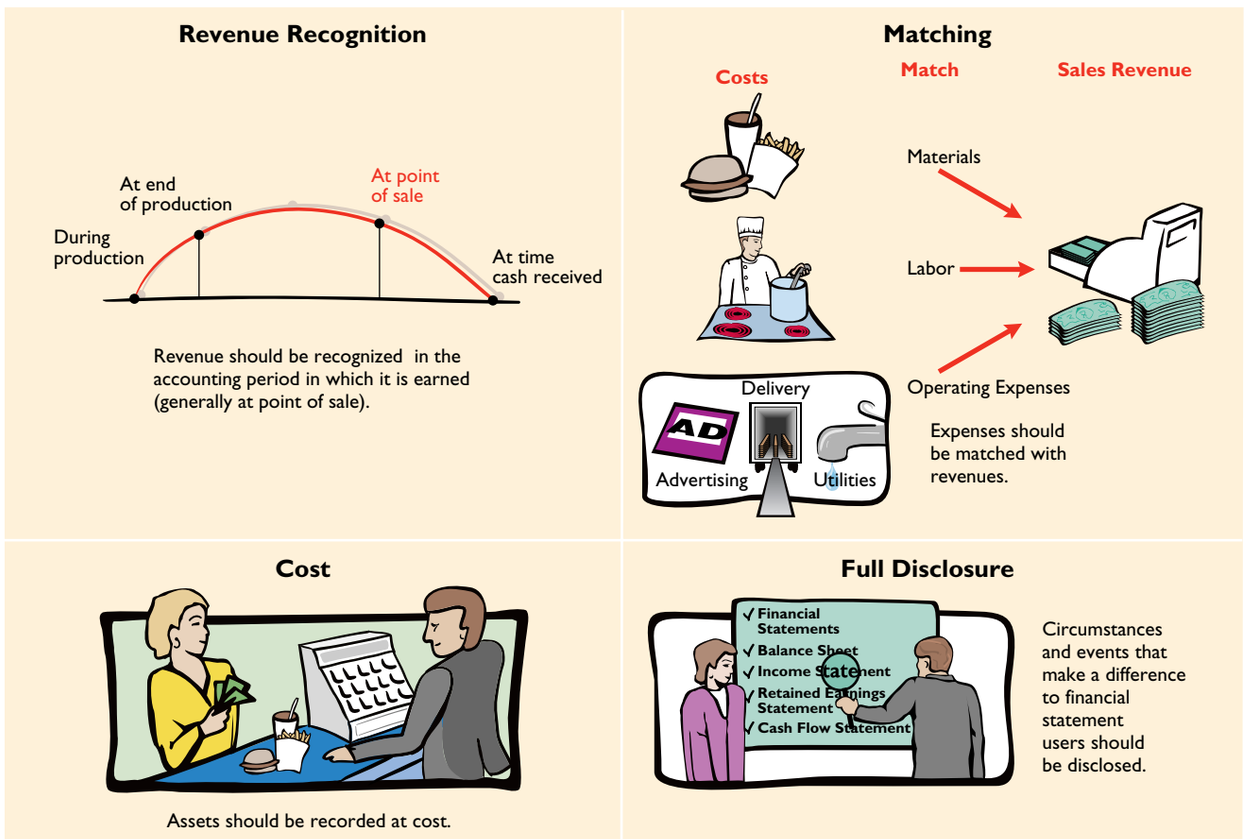
The basic principles of accounting are summarized in Illustration 2-5.

HELPFUL HINT

Are you a winner or loser when you hold cash in a period of inflation? Answer: A loser, because the value of the cash declines as inflation climbs.

Illustration 2-5

Basic principles used in accounting



CONSTRAINTS IN ACCOUNTING

Constraints permit a company to modify generally accepted accounting principles without reducing the usefulness of the reported information. The constraints are materiality and conservatism.

STUDY OBJECTIVE 6

Identify the two constraints in accounting.

[3]Adapted from *Barron's* (January 28, 1980), p. 27.

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MATERIALITY

Materiality relates to an item's impact on a firm's overall financial condition and operations. An item is **material** when it is likely to influence the decision of a reasonably prudent investor or creditor. It is immaterial if its inclusion or omission has no impact on a decision maker. In short, if the item does not make a difference in decision making, GAAP does not have to be followed. To determine the materiality of an amount, the accountant usually compares it with such items as total assets, total liabilities, and net income.

To illustrate how the materiality constraint is applied, assume that Rodriguez Co. purchases a number of low-cost plant assets, such as wastepaper baskets. Although the proper accounting would appear to be to depreciate these wastepaper baskets over their useful life, they are usually expensed immediately. This practice is justified because these costs are considered immaterial. Establishing depreciation schedules for these assets is costly and time consuming and will not make a material difference on total assets and net income. Another application of the materiality constraint would be the expensing of small tools. Some companies expense any plant assets under a specified dollar amount.

CONSERVATISM

HELPFUL HINT
In other words, if two methods are otherwise equally appropriate, choose the one that will least likely overstate assets and income.

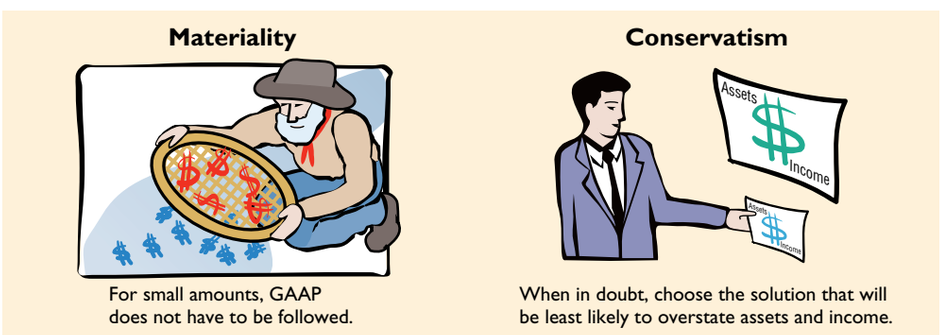
The **conservatism** constraint dictates that when in doubt, choose the method that will be least likely to overstate assets and income. *It does not mean understating assets or income.* Conservatism provides a reasonable guide in difficult situations: Do not overstate assets and income.

A common application of the conservatism constraint is the use of the lower of cost or market method for inventories. As Chapter 10 will show, inventories are reported at market value if market value is below cost. This practice results in a higher cost of goods sold and lower net income. In addition, inventory on the balance sheet is stated at a lower amount.

Other examples of conservatism in accounting are the use of the last-in, first-out (LIFO) method for inventory valuation when prices are rising and the use of accelerated depreciation methods for plant assets. Both these methods result in lower asset-carrying values and lower net income than alternative methods.

The two constraints in accounting are graphically depicted in Illustration 2-6.

Illustration 2-6
Constraints in accounting



SUMMARY OF CONCEPTUAL FRAMEWORK

As we have seen, the conceptual framework for developing sound reporting practices starts with a set of objectives for financial reporting. It follows with the description of qualities that make information useful. In addition, elements of financial statements are defined. More detailed operating guidelines are then provided. These guidelines take the form of assumptions and principles.

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The conceptual framework also recognizes that constraints exist on the reporting environment. The conceptual framework is illustrated graphically in Illustration 2-7.

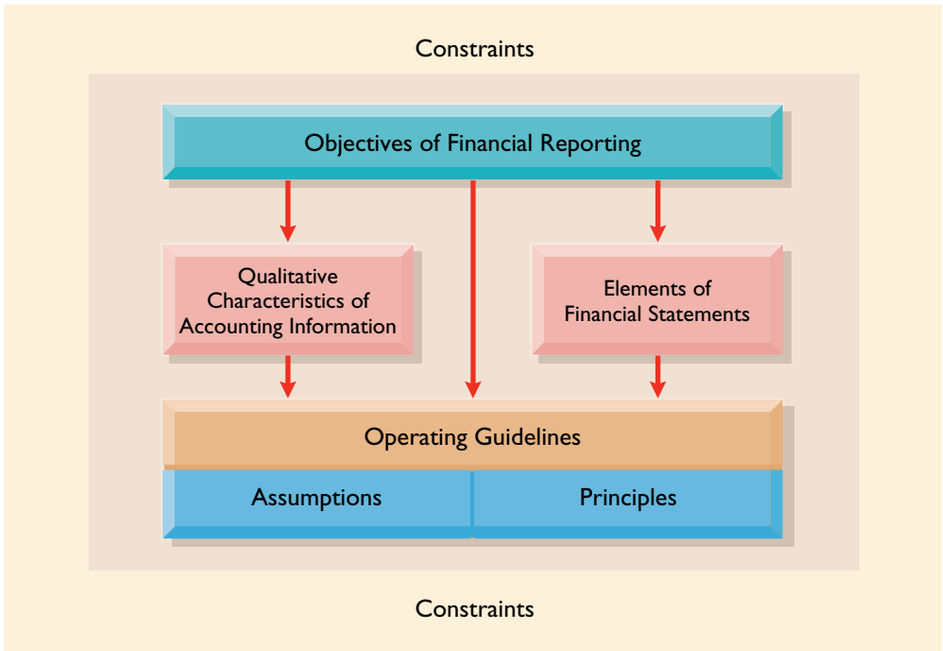


Illustration 2-7
Conceptual framework

BEFORE YOU GO ON...

REVIEW IT

1. What are the monetary unit assumption, the economic entity assumption, the time period assumption, and the going concern assumption?
2. What are the revenue recognition principle, the matching principle, the full disclosure principle, and the cost principle?
3. What are the materiality constraint and the conservatism constraint?

THE NAVIGATOR

STATEMENT PRESENTATION AND ANALYSIS

STUDY OBJECTIVE 7
Understand and analyze classified financial statements.

Financial statements play an important role in attempting to meet the objectives of financial reporting. "Bottom line" information such as total assets and net income are useful to investors, but these single numbers lack sufficient detail for serious analysis. Investors and creditors generally find the parts of a financial statement more useful than the whole. Proper classification within the financial statements is therefore extremely important.

CLASSIFIED BALANCE SHEET

The balance sheet is composed of three major elements: assets, liabilities, and stockholders' equity. Additional segregation within these groups, however, is considered useful to financial statement readers. As will be explained in Chapter 5, the accounts are generally classified as shown in Illustration 2-8.

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Illustration 2-8
Standard classification of balance sheet

Assets	Liabilities and Stockholders' Equity
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Property, plant, and equipment	Stockholders' equity
Intangible assets	

If the form of organization is a proprietorship, the term "Owner's equity" instead of Stockholders' equity is used to describe that section of the balance sheet. An account called Capital is reported in the owner's equity section of the balance sheet for a proprietorship. **Capital** is the owner's investment in the business.

To illustrate, assume that Sally Field invests $90,000 on July 10, 2004, to start up Birthday Balloons. The company's balance sheet immediately after the investment looks like Illustration 2-9.

Illustration 2-9
Proprietorship balance sheet

BIRTHDAY BALLOONS
Balance Sheet
July 10, 2004

Cash	$90,000	Sally Field, Capital	$90,000

Because Sally Field owns the business and has chosen not to incorporate, common stock is not issued and net income (net loss) belongs to her. Therefore, common stock and retained earnings accounts are not needed. Instead, her capital account is increased by investments and by net income. It is decreased by withdrawals of assets for personal use and by net losses. The capital account represents Sally Field's claim to the net assets (assets less liabilities) of the company.

HELPFUL HINT
Note "Owners' equity" instead of "Owner's equity" is used for a partnership to indicate multiple owners.

If the form of organization is a partnership, each partner has a separate capital account, and the owners' equity section shows the capital accounts of all the partners. For example, assume that A. Teller and B. Penn form a partnership on December 11, 2004, at which time Teller and Penn each invest $60,000. The balance sheet immediately after their investments looks like Illustration 2-10.

Illustration 2-10
Partnership balance sheet

TELLER AND PENN
Balance Sheet
December 11, 2004

Cash	$120,000	A. Teller, Capital	$ 60,000
		B. Penn, Capital	60,000
			$120,000

CLASSIFIED INCOME STATEMENT

Chapter 7 presented a multiple-step income statement for Sellers Health Foods. The multiple-step income statement included the following.

Sales revenue section—Presents the sales, discounts, allowances, and other related information to arrive at the net amount of sales revenue.

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Cost of goods sold—Indicates the cost of goods sold to produce sales.

Operating expenses—Provides information on both selling and administrative expenses.

Other revenues and gains—Indicates revenues earned or gains resulting from nonoperating transactions.

Other expenses and losses—Indicates expenses or losses incurred from nonoperating transactions.

Two additional items are income tax expense and earnings per share.

Income Tax Expense

Income taxes must be paid and therefore reported for a corporation because a corporation is a legal entity separate and distinct from its owners. Proprietorships and partnerships are not separate legal entities; owners are therefore taxed directly on their business income. Stockholders are taxed only on the dividends they receive.

Corporate **income taxes** (or **income tax expense**) are reported in a separate section of the income statement, before net income. The condensed income statement for Hallmark Hotel Brokerage in Illustration 2-11 shows a typical presentation. Note that Income before income taxes is reported before Income tax expense.

HALLMARK HOTEL BROKERAGE
Income Statement
For the Year Ended December 31, 2004

Sales	$800,000
Cost of goods sold	600,000
Gross profit	200,000
Operating expenses	50,000
Income from operations	150,000
Other revenues and gains	10,000
Other expenses and losses	4,000
Income before income taxes	**156,000**
Income tax expense	**46,800**
Net income	$109,200

Illustration 2-11
Income statement with income taxes

HELPFUL HINT
Corporations may also use the single-step form of income statements discussed in Chapter 7.

Income tax expense and the related liability for income taxes payable are recorded as part of the adjusting process, preceding financial statement preparation. Using the data above for Hallmark Hotel Brokerage, the adjusting entry for income tax expense at December 31, 2004, would be as follows.

Income tax expense	46,800	
Income taxes payable		46,800
(To record income taxes for 2004)		

A	=	L	+	SE
		+46,800		−46,800

Earnings Per Share

Earnings per share data are frequently reported in the financial press and are widely used by stockholders and potential investors in evaluating the profitability of a company. Investors, especially, attempt to link earnings per share to the

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market price per share.[4] **Earnings per share (EPS)** indicates the net income earned by each share of outstanding common stock. Thus, **earnings per share is reported only for common stock**. Illustration 2-12 gives the formula for computing earnings per share when there has been no change in outstanding shares during the year.

Illustration 2-12

Earnings per share formula—no change in outstanding shares



For example, Hallmark Hotel Brokerage (Illustration 2-11) has net income of $109,200. Assuming that it has 54,600 shares of common stock outstanding for the year, earnings per share are $2 ($109,200 ÷ 54,600).[5]

Because of the importance of earnings per share, most companies are required to report it on the face of the income statement. Generally this amount is simply reported below net income on the statement. For Hallmark Hotel Brokerage the presentation would be as in Illustration 2-13.

Illustration 2-13

Basic earnings per share disclosure

HALLMARK HOTEL BROKERAGE
Income Statement (partial)
For the Year Ended December 31, 2004

Net income	$109,200
Earnings per share	**$2.00**

ANALYZING FINANCIAL STATEMENTS

The financial statements should provide financial information that is useful for helping make sound investment and credit decisions. Illustration 2-14 shows the condensed balance sheet and income statement of Blue Ribbon Meats, for 2004.

Illustration 2-14

Financial statements—Blue Ribbon Meats, Inc.

BLUE RIBBON MEATS, INC.
Balance Sheet
December 31, 2004

Assets		Liabilities and Stockholders' Equity	
Current assets	$156,000	Current liabilities	$ 70,000
Plant and equipment (net)	74,000	Long-term liabilities	114,000
Intangible assets	14,000	Stockholders' equity	60,000
Total assets	$244,000	Total liabilities and stockholders' equity	$244,000

[4]The ratio of the market price per share to the earnings per share is referred to as the *price-earnings ratio*. This ratio is reported in the *Wall Street Journal* and other newspapers for common stocks listed on major stock exchanges.

[5]Whenever the number of outstanding shares changes during the year, the calculation of EPS becomes more complicated.

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BLUE RIBBON MEATS, INC.
Income Statement
For the Year Ended December 31, 2004

Net sales	$430,000
Cost of sales	295,000
Gross profit	135,000
Selling and administrative expenses	109,000
Income from operations	26,000
Other expenses and losses	5,000
Income before income taxes	21,000
Income tax expense	7,000
Net income	$ 14,000
Earnings per share	$0.35

Illustration 2-14
Financial statements—Blue Ribbon Meats, Inc., *Continued*

In analyzing and interpreting financial statement information, three major characteristics are generally evaluated: **liquidity, profitability**, and **solvency**. A **short-term debt holder**, for example, is primarily interested in the ability of a borrower to pay obligations when they become due. The liquidity of the borrower in such a case is extremely important in assessing the safety of a loan. A **long-term debt holder**, however, looks to indicators such as profitability and solvency that point to the firm's ability to survive over a long period of time. Long-term debt holders analyze earnings per share, the relationship of income to total assets invested, and the amount of debt in relation to total assets to determine whether money should be lent and at what interest rate. Similarly, **stockholders** are interested in the profitability and solvency of a company when assessing the likelihood of dividends and the growth potential of the common stock.

Liquidity

What is Blue Ribbon Meats' ability to pay its maturing obligations and meet unexpected needs for cash? The relationship between current assets and current liabilities is critical to helping answer this question. These relationships are expressed as a ratio, called the **current ratio**, and as a dollar amount, called **working capital**.

CURRENT RATIO. The **current ratio** is current assets divided by current liabilities. For Blue Ribbon Meats, Inc., the ratio is 2.23:1, computed in Illustration 2-15.

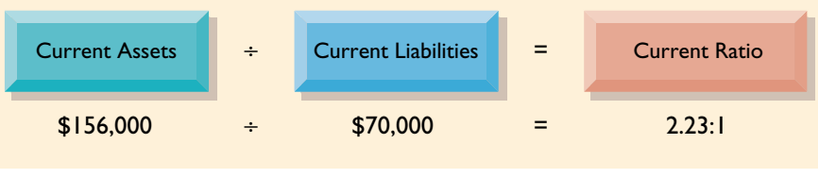


Illustration 2-15
Current ratio formula and computation

This ratio means that current assets are more than two times greater than current liabilities. Bankers, other creditors, and agencies such as **Dun & Bradstreet** use this ratio to determine whether the company is a good credit risk. Traditionally, a ratio of 2:1 is considered to be the standard for a good credit rating. Today, however, many sound companies have current ratios of less than 2:1. Hotel and restaurant companies normally have a 0.8:1 to 1.2:1 current ratio. With its 2.23:1 ratio,

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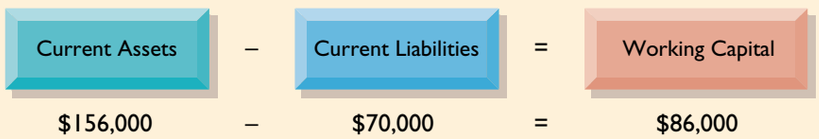
Blue Ribbon Meats' short-term debt-paying ability appears to be very favorable.

From the foregoing, you might at first assume that the higher the current ratio, the better. This is not necessarily true. A very high current ratio may indicate that the company is holding more current assets than it currently needs in the business. It is possible, therefore, that the excess resources might be directed to more profitable investment opportunities.

WORKING CAPITAL. The excess of current assets over current liabilities is called **working capital**. For Blue Ribbon Meats, Inc., working capital is $86,000, as shown in Illustration 2-16.

Illustration 2-16

Working capital formula and computation



The amount of working capital provides some indication of the company's ability to meet its existing current obligations. A large amount of working capital generally means a company can meet its current liabilities as they fall due and, if desired, pay dividends. Although no set standards exist for the level of working capital a company should maintain, the general adequacy of a company's working capital is often determined by comparing data from prior periods and from similar companies of comparable size. Blue Ribbon Meats' working capital appears adequate.

Profitability

Profitability ratios measure the income or operating success of an enterprise for a given period of time. Income, or the lack of it, affects the company's ability to obtain debt or equity financing and the company's ability to grow.

PROFIT MARGIN PERCENTAGE. One important ratio used to measure profitability is the **profit margin percentage** (or rate of return on sales). It measures the percentage of each dollar of sales that results in net income. It is calculated by dividing net income by net sales for the period. Blue Ribbon Meats, Inc.'s profit margin percentage is 3.3 percent, computed in Illustration 2-17.

Illustration 2-17

Profit margin formula and computation



This ratio seems low. Much, however, depends on the type of industry. High-volume retailers, such as grocery stores (**Safeway** or **Kroger**) or discount stores (**Wal-Mart** or **Target**), generally have a low profit margin. They make a small profit on each sale but have many sales.

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ACCOUNTING IN ACTION *Business Insight*



The type of industry can make a difference in the profit margin percentage investors and creditors expect. Profit margins among service companies—from airlines and banks to telecommunications companies and utilities—have traditionally been lower than those among manufacturers. **Starwood Hotels & Resorts Worldwide Inc.,** for example, showed a profit margin percentage of 3.8 percent in 2001, which is average for a hotel company. **Choice Hotels International, Inc.**'s profit margin percentage was 4.2 percent, and **LaQuinta** posted a loss. **Morton's Restaurant Group Inc.,** which will be compared to the foodservice group, reported a 0.4 percent profit margin for 2001. For the same period, **McDonald's Corp.** posted an 11 percent profit, while **Brinker International, Inc.** was more at the average rate of 4.9 percent. Before using a ratio like the profit margin percentage to evaluate company performance, you need to know what is reasonable performance for the industry.

RETURN ON ASSETS. In making an investment, an investor wants to know what rate of return to expect and what risks are associated with that rate of return. The greater the risk, the higher the rate of return the investor will demand on the investment.

One overall measure of profitability of a company is its rate of **return on assets**. It is calculated by dividing net income by total assets.[6] Blue Ribbon Meats, Inc.'s rate of return is 5.7 percent, computed in Illustration 2-18.

Net Income	÷	Total Assets	=	Return on Assets
$14,000	÷	$244,000	=	5.7%

Illustration 2-18
Return on assets formula and computation

The rate of return on assets is relatively low, which suggests that Blue Ribbon Meats might not be using its assets effectively.

RETURN ON COMMON STOCKHOLDERS' EQUITY. Another widely used rate that measures profitability from the common stockholders' viewpoint is **return on common stockholders' equity**. This rate shows the percentage of net income earned for each dollar of owners' investment. It is calculated by dividing net income by common stockholders' equity. In Blue Ribbon Meats, Inc.'s case, the rate of return is 23.3 percent (or 23.3 cents per dollar), computed in Illustration 2-19.

Net Income	÷	Common Equity	=	Return on Common Stockholders' Equity
$14,000	÷	$60,000	=	23.3%

Illustration 2-19
Return on common stockholders' equity formula and computation

[6] For simplicity, the rate of return calculations are based on end-of-year total amounts. The more conceptually correct *average* total assets and *average* common stockholders' equity are used in later chapters.

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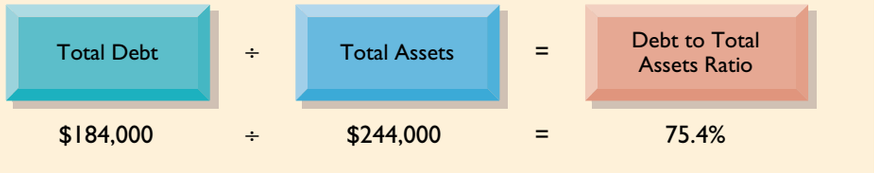
Blue Ribbon Meats' return on common stockholders' equity is quite good. The reason for this high rate of return is that Blue Ribbon Meats' assets are earning a return higher than the borrowing costs the company incurs.

Solvency

Solvency measures the ability of an enterprise to survive over a long period of time. Long-term debt holders and stockholders are interested in a company's ability to pay periodic interest and to repay the face value of the debt at maturity.

DEBT TO TOTAL ASSETS. One useful measure of solvency is the **debt to total assets ratio**. It measures the percentage of total assets that creditors, as opposed to stockholders, provide. It is calculated by dividing total debt (liabilities) by total assets, normally expressed as a percentage. Blue Ribbon Meats, Inc.'s debt to total assets ratio is 75.4 percent, computed in Illustration 2-20.

Illustration 2-20
Debt to total assets formula and computation



Debt to total assets of 75.4 percent means that Blue Ribbon Meats' creditors have provided approximately three-quarters of its total assets. The higher the percentage of debt to total assets, the greater the risk that the company may be unable to meet its maturing obligations. The lower the percentage, the greater the "buffer" available to creditors should the company become insolvent. In Blue Ribbon Meats' case, unless earnings are positive and very stable, the company may have too much debt.

These percentage and ratio relationships are often used in comparison with (1) expected results, (2) prior year results, and (3) published results of other companies in the same line of business. Conclusions based on a single year's results are hazardous at best.

FINANCIAL STATEMENT PRESENTATION— AN INTERNATIONAL PERSPECTIVE

STUDY OBJECTIVE 8
Explain the accounting principles used in international operations.

World markets are becoming increasingly intertwined. Foreigners use American computers, eat American breakfast cereals, read American magazines, listen to American rock music, watch American movies and TV shows, and drink American soda. Americans drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, and use Arabian oil. The variety and volume of exported and imported goods indicates the extensive involvement of U.S. business in international trade. Many U.S. companies consider the world their market.

Firms that conduct operations in more than one country through subsidiaries, divisions, or branches in foreign countries are referred to as **multinational corporations (MNCs)**. The accounting for such corporations is complicated because foreign currencies are involved. These international transactions must be translated into U.S. dollars.

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Differences in Standards

In the new global economy many investment and credit decisions require the analysis of foreign financial statements. Unfortunately, accounting standards are not uniform from country to country. This lack of uniformity results from differences in legal systems, in processes for developing accounting standards, in governmental requirements, and in economic environments.

ACCOUNTING IN ACTION *International Insight*



Research and development costs are an example of different international accounting standards. Compare how four countries account for research and development (R&D):

Country	Accounting Treatment
United States	Expenditures are expensed.
United Kingdom	Certain expenditures may be capitalized.
Germany	Expenditures are expensed.
Japan	Expenditures may be capitalized and amortized over 5 years.

Thus, an R&D expenditure of $100 million is charged totally to expense in the current period in the United States and Germany. This same expense could range from zero to $100 million in the United Kingdom and from $20 million to $100 million in Japan!

Do you believe that accounting principles should be comparable across countries?

Uniformity in Standards

Efforts to obtain uniformity in international accounting practices are taking place. In 1973 the **International Accounting Standards Committee (IASC)** was formed by agreement of accounting organizations in the United States, the United Kingdom, Canada, Australia, France, Germany, Japan, Mexico, and the Netherlands. Its purpose is to formulate international accounting standards and to promote their acceptance worldwide.

To date, numerous standards have been issued for IASC members to introduce to their respective countries. But, the IASC has no enforcement powers, so these standards are by no means universally applied. They are, though, generally followed by the multinational companies that are audited by international public accounting firms. The foundation has been laid for progress toward greater uniformity in international accounting.

THE UNIFORM SYSTEMS OF ACCOUNTS AND FINANCIAL REPORTING

STUDY OBJECTIVE 9

Identify the various systems of accounting procedures used in the hospitality industry.

Although FASB sets the rules for public accounting that must be abided by the accounting profession, the hospitality industry also sets procedures and guidelines for its various segments to ensure comparability, accountability, and meaningful usage of accounting data. For new operators, these systems even act as turnkey accounting systems. This means the system has everything included and is ready to be used in operations. The three most used and well-known systems in the in-

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dustry are for the lodging, foodservice, and club areas. There is currently one under development for the gaming industry.

Why are such industry-specific systems needed? If every industry follows FASB's rules, shouldn't they then have the correct accounting information? In theory, yes. However, the rules for FASB are written for the entire accounting profession. Hospitality has accounts other industries do not, and vice versa. For instance, a restaurant will not have a depletion account for an oil rig, but a restaurant does need an accumulation depreciation account for furniture, fixtures, and equipment. Even within the hospitality industry there are differences. A hotel is different from a club and a club is different from a theme park. Hotels have rooms revenues, country clubs have membership dues, and theme parks have admissions fees. There are recommended procedures to categorize certain expenses or naming of accounts. The accounting information provided is more useful not just for the companies themselves but also for investors, creditors, and even employees.

LODGING INDUSTRY

The **Uniform System of Accounts for the Lodging Industry** is currently in its ninth edition. Of the three systems, this is the oldest. It was first developed by the Hotel Association of New York in 1926 and was known as the Uniform System of Accounts for Hotels. From the 1930s to the 1970s, when most hotels were smaller and motor hotels (motels) were popular, there were actually two systems: the Uniform System of Accounts for Hotels and the Uniform System of Accounts for Smaller Hotels. There was also an expense dictionary where expenditures were categorized under specific accounts so that accountants and controllers could follow the allocation trail.

The ninth edition evolved with industry trends and combines all three books into a seamless system of accounts for the entire lodging industry. The **Hospitality Financial and Technology Professionals (HFTP)** is working with the American Hotel and Lodging Association on the next edition.

FOODSERVICE INDUSTRY

The **Uniform System of Accounts for Restaurants**, first published in 1927, is currently in its seventh edition. It provides sample statements, analyses blueprints, classification of accounts, and an expense dictionary. The aim of this publication, like that of the lodging and club industries, is to assist operators to interpret financial results in a more meaningful manner.

CLUB INDUSTRY

The club industry is a self-regulating industry. With its owners also being its members, accountability is of utmost importance. The **Club Managers Association of America (CMAA)** was formed in 1927 and published the Proposed Uniform System of Accounts for City Clubs in 1942. It was not until 1954 that the first Uniform System of Accounts for Clubs was published. The current fifth edition is known as the **Uniform System of Financial Reporting for Clubs.**

Similar to the hotel industry, the club industry has seen tremendous growth, especially in real estate developments. Many new residential developments also include a club, fully equipped with all amenities and services, including one, and perhaps two, golf courses for its residents.

GAMING INDUSTRY

You may feel that if any industry needs a system, the casino industry should be the first one to have a set of procedures because there are such large amounts of money involved. However, the first edition of this system is still under development. Two reasons contribute to the late birth. First, both Nevada and New Jersey have strict laws governing the operations of casinos, including how money

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transactions should be documented. Many states with legalized gaming have adopted the rules of Nevada and New Jersey. In addition, casinos have been using parts of the system from the lodging industry. In the current ninth edition of the system of the lodging industry, there are also sections dedicated to the casino industry, suggesting statement presentation formats and guidelines.

ACCOUNTING AND FINANCIAL MANAGEMENT IN HOSPITALITY

HOTEL OPERATIONS

STUDY OBJECTIVE 10
Understand accounting and financial management in a hotel.

Operating a hotel is like being in charge of a small city. The hotel business is full of exciting moments, surprises, heartwarming stories, and also some tough workdays. If you can imagine a mayor taking care of a city, well, that is what a general manager has to do for his or her hotel. The general manager needs to have the hotel properly staffed, with the right equipment and supplies, so guests can have a wonderful experience. *Hospitality* is not just the name that encompasses the industry but is also the key word to success.

While the feature story about Conrad N. Hilton in Chapter 1 emphasizes the need for hospitality, planning and controls through prudent and ethical financial management are equally important. The role of financial management in a hotel is crucial to its success. Reduced to the simplest terms, when the money is not there, the hotel cannot open. The hotel industry really offers a fascinating career. Visit the **American Hotel and Lodging Association (AH&LA)** Web site (www.ahla.com) for more information about the hotel industry from national to local levels.

Interactions with All Departments

A typical hotel is divided into departments. The bigger the hotel, the more departments it has. Most hotels have a front office that takes care of reservations and registration. There is also a housekeeping department and an engineering and maintenance department. If the hotel is a full-service property, it will have a food and beverage department, which may include restaurant, banquet, and in-room dining. Smaller properties may have their human resources and accounting functions centralized at a regional office. An accounting department at a 1,600-room convention property may have forty to fifty employees. Illustration 2-21 shows a sample organization chart for a full-service hotel.

Regardless of how many departments and how many employees, you can see the big picture. In the hotel business, it takes teamwork to provide the ultimate quality service and product to the guests. Five hundred convention attendees staying with the hotel expect to have their rooms ready for check-in and meeting rooms available for work. They will also expect their coffee and meal breaks served on time and the banquet room decorated with their association's banner and other materials. The group's convention organizer is not going to talk to the housekeeper, the restaurant manager, the banquet captain, or the front office separately regarding their needs. This organizer will have one point of contact with the hotel sales and catering office and this hotel manager will need to interact with all departments to communicate the pertinent information. Thus, all departments need to interact and make decisions accordingly.

The General Manager and the Executive Committee

As mentioned, the **general manager** is like the mayor of the city. He or she will work closely with the members of the **executive committee** to manage the hotel.

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The executive committee is made up of all the department heads. This group comes together for meetings to make decisions and ensure all information is relayed correctly.

The **controller**, the department head of the accounting department, is a member of the executive committee. Just like the general manager, the controller has to work not only with the employees in the accounting and business office, but also with all department heads. At times, while certain department heads may not need to have constant communication with one another, the controller, as the head financial management person, is required to do so.

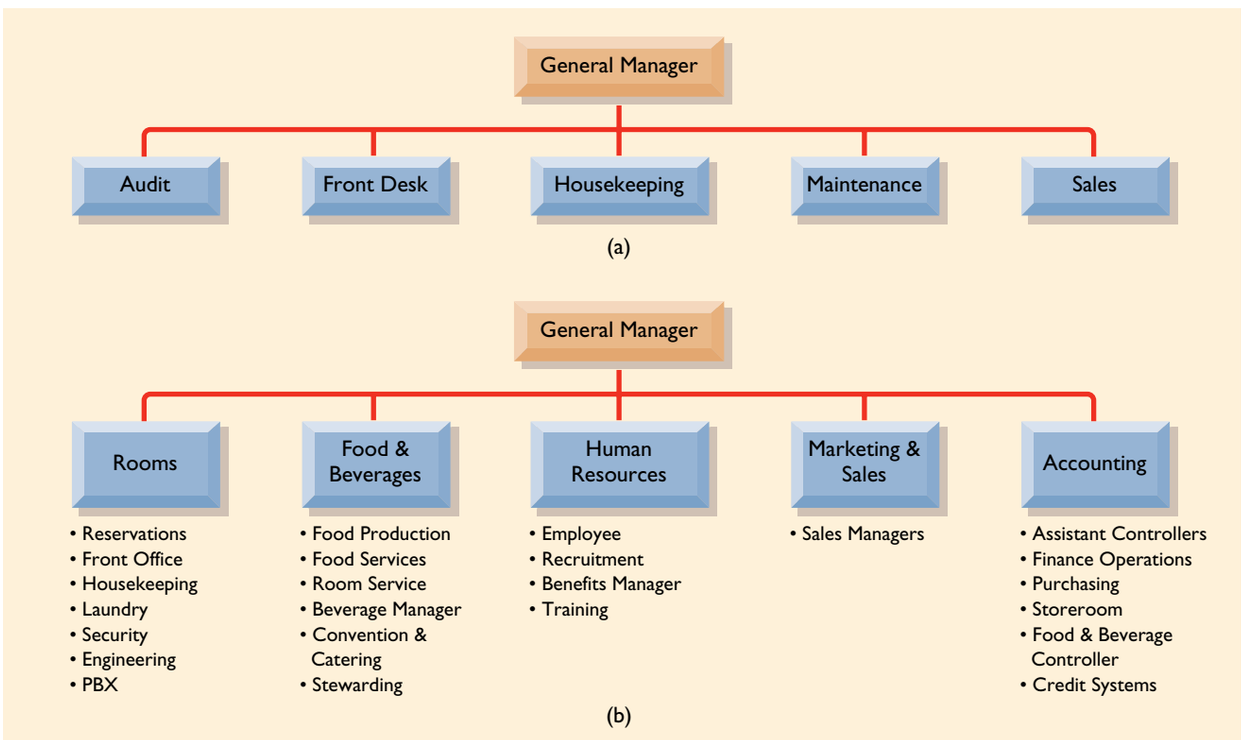
Controllers need to know how every department performs and whether each department is making or losing money. They can do so from a simple analysis of the departmental income statement. They can then consult with department heads to point out any concerns that are shown on the financial records. This allows departments to take appropriate actions to ensure the success of the hotel. In the career ladder of a hotel, it is highly possible that a controller can one day become the general manager.

The Casino Hotel

Financial management is important in any hotel. However, it is doubly important in a casino hotel. Think of all the cash that passes through a casino on a daily basis. We are talking about thousands to millions of dollars. The exchange of cash for playing chips, the emptying of cash at slot machines and the table games, the issuing of credit to guests, even the counting of coins and paper money, has set procedures regulated by the hotels and by the law. Therefore, besides taking care of all the billing, cash, and payables of a regular hotel, the accounting functions in a casino hotel include managing all other revenue centers from all the games. This makes a controller's function more interesting and challenging.

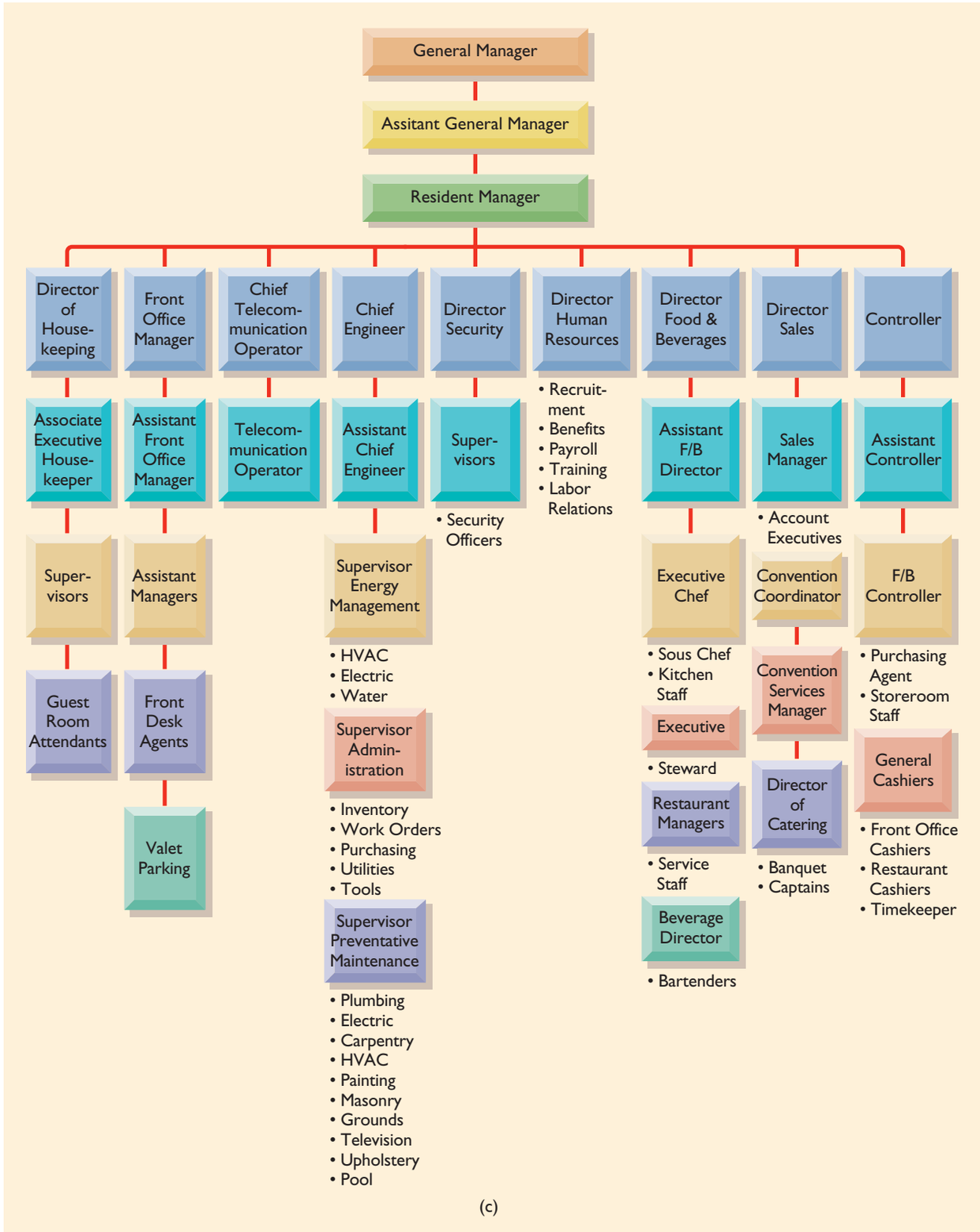
Illustration 2-21

Departmental structure in the hotel and lodging industry: (a) departments of a limited-service hotel; (b) departments of a full-service hotel (under 500 rooms); (c) departments of a full-service hotel (over 500 rooms). *Source:* Alan Stutts, *Hotel and Lodging Management: An Introduction* (New York: Wiley, 2001). This material is used by permission of John Wiley & Sons, Inc.



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Illustration 2-21
Continued



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HOTEL ACCOUNTING DEPARTMENT ORGANIZATION

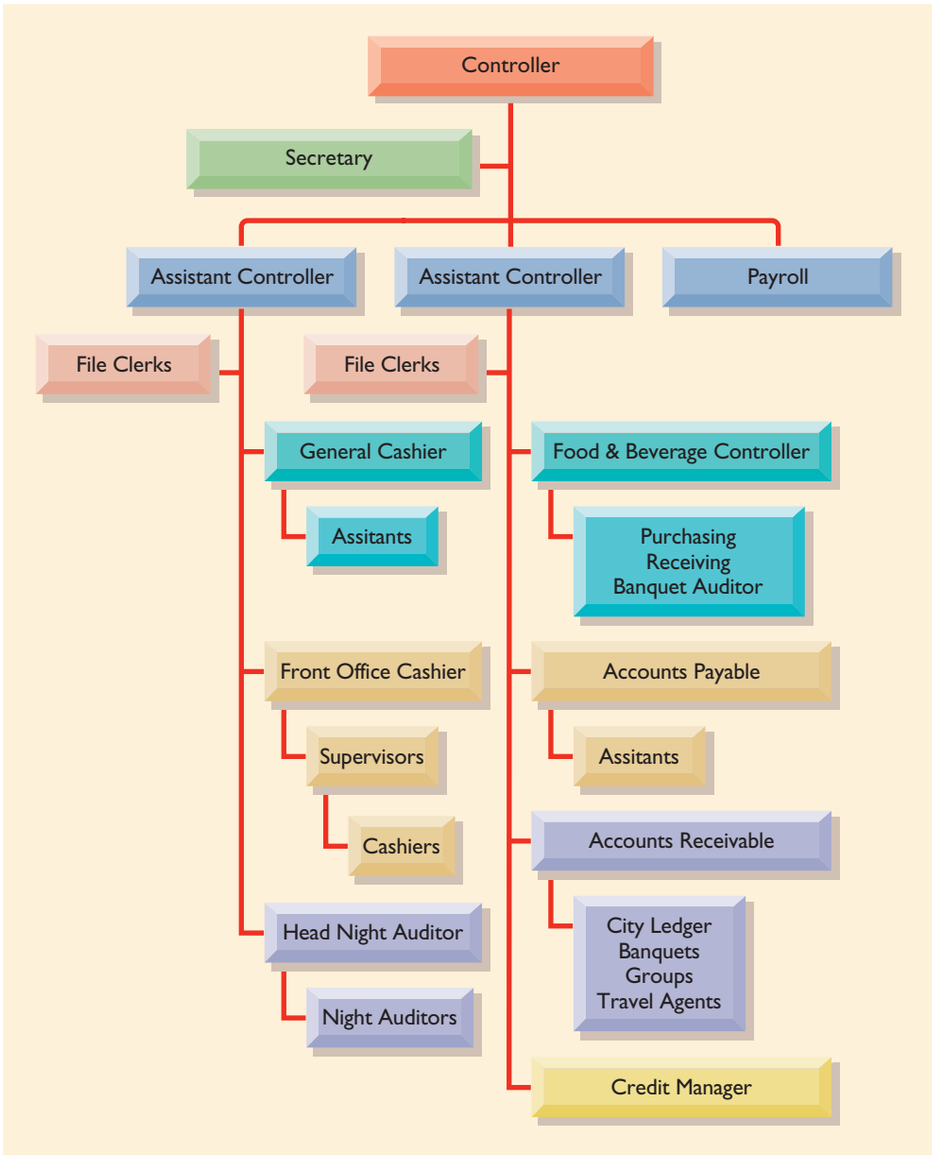
There are many users of accounting and financial information. It takes quite a bit of work to make sure that records are kept properly for all parties. Illustration 2-22 is an organizational chart of a large hotel's accounting department. This organization depends on the size of the hotel. Some hotels may not have a need for an assistant controller; some of the other functions may not exist in a hotel, such as a food and beverage department. For most limited-service hotels, the general manager may assume the function of the controller, or that function will be centralized at a district or regional office. Following is a short description of some of the accounting functions in a hotel.

Accounts Payable

A key area in accounting, accounts payable ensures that all bills are paid on time and all discounts are taken minimizing the costs of the hotel. Accounts payable

Illustration 2-22

An organization chart of a large hotel accounting department



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clerks work closely with the purchasing department to verify that all invoices to be paid are indeed invoices of the hotel.

Assistant Controller

In a big hotel, you may see one, or a few, assistant controllers. In smaller hotels, there may not be any. The controller divides the various functions to be performed so that the workload will be even. For example, one assistant might be responsible for daily transactions while another works on special projects, budgets, analyses, and the like.

Guest and City Ledgers

A hotel keeps two ledgers: the guest ledger is associated with the guests staying at the hotel while the city ledger contains all other billings. It is important that the accounting department has a person in accounts receivable working with the city ledger so the hotel is able to bill and collect revenues due.

Night Audit

Night auditors get their name because of the hours they work. At the end of the day after most hotel guests have retired, these auditors begin recording charges to guests' accounts and verifying the revenue for the hotel. However, with computers and various technologies, the hotel industry can post charges instantaneously. Some hotels have actually changed the night auditors to become day auditors.

Banquet Auditor

Besides revenues charged to guest rooms, a large hotel earns the bulk of its food and beverage revenues through banquets. The banquet auditor's function is to verify the correct revenue for billing. This individual works closely with the banquet staff, the sales office staff, and the accounts receivable clerks.

Credit

A big hotel may have its own credit manager whose function is to check and grant credit. In today's business world, many transactions are done on credit rather than cash or cashier checks. It is, therefore, the credit manager's responsibility to conduct such investigations to be sure that a person or company is creditworthy.

Food and Beverage Controller

This is a fun and challenging position, as it has both accounting and food and beverage components. While performing all analyses of food cost percentage, yields on meat, and menu costings, the food and beverage controller also works with the chef to design new menu items, taste new products, and even be a mystery diner to taste-test the menus in other foodservice establishments.

Front-Office Cashiers

The duties of a front-office cashier are often incorporated with the front-office personnel. When guests check out, it is the duty of these cashiers to charge the guests the correct amount and secure a form of payment.

General Cashier

Pause for a minute and think how many cash banks there are in a large hotel: a few at the front office, at least one in the restaurant, at least one in the gift shop,

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and so on. The general cashier is the person who is in charge of all the cash banks in the hotel. He or she also makes all deposits of checks and credit card receipts.

Operations Analyst

This is a nice position to have in a hotel. An operation analyst performs analyses to help managers operate the hotel more effectively. From guests' statistics to revenue trends, the operations analyst does it all. However, not all hotels are able to afford an analyst on the payroll. If this is the case, an assistant controller often performs these duties. For smaller hotels where there is not an accounting office on the property, this function is done at the regional level.

Payroll

Payroll employees calculate the pay rate with the hours worked to do the payroll so paychecks are released on time. Payroll functions also include filing all payroll taxes and tip credits for tipped employees, as well as keeping track of vacation, sick pay, and other payroll-related deductions.

Systems Manager

A systems manager is not depicted in Illustration 2-22. Since the various accounting functions cover the entire hotel operation, the systems manager or systems analyst, whose job is to take care of all technology issues, is normally founded within the accounting department. In a smaller hotel, the controller or an assistant controller may take on this responsibility. Normally, this position is found at a regional or corporate level and systems analysts will be dispatched to assist the property when needed.

FOODSERVICE OPERATIONS

STUDY OBJECTIVE 11

Understand accounting and financial management in a foodservice operation and a club.

The controller of an independent restaurant or a foodservice operation is similar to that of a food and beverage controller at a hotel. The difference is that the foodservice controller concentrates on only the food and beverage side, whereas a hotel controller oversees various departments of a hotel. Therefore, besides labor cost and overhead items, accounting and financial management in the foodservice business is focused on yield analysis, food and beverage cost control, and the purchasing function.

Purchasing and Yield Analysis

Foodservice operations purchase food, beverages, and other items on a day-to-day basis. In the case of food and beverage, because products are perishable, buying the right amount of food, at the right quality, at the right time, reduces the amount of cash tied in inventory. The extra cash then provides more liquidity to the business.

When buying food and beverage, yield is important. A good-quality piece of beef may have less trimmings, yielding the foodservice operation more meat products to be sold. A can of tomatoes may just look like another can. But if the controller performs a "can-cutting" and compares the two brands, he or she might discover that one is better than the other and the cost difference might work to the advantage of the operation.

Food and Beverage Cost Analysis

In general, for a restaurant or operation that sells alcoholic beverages (liquor, beer, and wine), it is not unusual to have 15 to 30 percent of its total sales derived from

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beverages. This means 70 to 85 percent of the sales are made from food items. For smaller restaurants and quick-service operations that do not sell alcoholic beverages, all revenue comes from food sales. Therefore, the accounting department spends a lot of time tracking food costs. This is especially important because foodservice operations use products where prices often fluctuate.

Restaurants and operations that sell alcoholic beverages will also track beverage costs and perform various analyses. Do not think for a minute that because beverage sales are only 15 percent of total sales they are not important. First, the restaurant business is a "penny" business. One needs to watch for any penny that is earned or spent; otherwise, the profit margin can easily disappear if the business is not managed wisely. More important, the markup of beverages is very high. A bottle of wine that can be purchased retail for $15 can be sold at the restaurant from $40 to $60, depending on the type of restaurant.

Thus, careful cost analysis provides foodservice operators with useful information for product purchasing and pricing to maximize profits, while offering guests the products they prefer and enjoy. For those who are interested in the restaurant segment, please visit the **National Restaurant Association** Web site at www.restaurant.org.

CLUB OPERATIONS

The club segment of the hospitality industry in North America is substantial. In every major city there are many country clubs. But clubs are not just country clubs. They also include city clubs, yacht clubs, racquet clubs, tennis clubs, other athletic clubs, military clubs, and university clubs. These private clubs are membership-only operations. In 2001, The Club Managers Association of America reported more than 11,000 private clubs in the United States. Since these clubs are restrictive of clientele, the way business is carried out and, thus, the way accounting is performed is quite different from the foodservice and hotel segments of the hospitality industry.

Membership Accounting

While hotels have rooms, food, beverage, and other miscellaneous revenues, and restaurants have food, beverage, and other revenues, clubs have all of these and a unique revenue category—membership dues. Membership dues from country clubs often make up to 50 percent of a club's revenue, while food and beverage percentage is about 35 percent, with other revenues of 15 percent or so rounding up the 100 percent. These other revenues can include athletic fees for guests, golf greens fees for guests, and sales of merchandise in pro shops and gift stores. In city clubs, food and beverage revenues often exceed that of membership, as golf membership is normally not provided in a city club environment. Membership revenues are the main source of funds needed for a club to run its operations.

Golf, Tennis, and Spas

Golf, tennis, and spas are three of the major athletic packages included in many club dues. Depending on the type of club, the initiation fees can run from $10,000 to easily more than $100,000. In certain clubs, you need to be invited and sponsored by existing members before you are put on a waiting list to join. There are also various levels of membership. A full membership will entitle the member to play golf, tennis, and use the athletic and spa facilities, while a social membership will permit the member to use only the food and beverage outlets.

The club accounting department needs to treat each of these outlets as a cost center, just like a restaurant in a hotel or a gift shop, determining the profit and loss of each area. This gives management the needed information to make sound operating decisions.

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BEFORE YOU GO ON...

REVIEW IT

1. What is the major difference in the equity section of the balance sheet between a corporation and proprietorship?
2. Where are income tax expense and earnings per share reported on the income statement? How is earnings per share computed?
3. How are the current ratio, working capital, profit margin percentage, return on assets, return on common stockholders' equity, and debt to total assets computed?
4. Explain how these ratios are useful in financial statement analysis.
5. What is the purpose of the International Accounting Standards Committee?
6. What are the three accounting guidelines publications for the hotel, restaurant, and club segments of the industry?
7. Identify and briefly explain the various positions available in an accounting department in a hotel operation.
8. Identify at least three areas in a club accounting operations which differ from that of a hotel operation.

A LOOK BACK AT OUR FEATURE STORY

Refer back to the Feature Story at the beginning of the chapter and the following situations.

1. **Medco's** initial public offering to sell its stocks was stopped by Merck. It reported $14 billion of revenues from co-payments made by patients. Such co-payments went to drug retailers and others, rather than Medco. Is the concept of revenue recognition violated in this situation? Explain.
2. **Adelphia Communications** booked marketing support payments by Motorola and Scientific-Atlanta as sales. Adelphia would pay these companies an extra amount for decoders sold and in turn, these companies will return to Adelphia such amounts as marketing support payments. Since sales were increased, so was the EBITDA.

SOLUTION

1. The revenue recognition principle dictates that revenue should be recognized in the accounting period in which it is earned. Revenue is generally recognized at the point of sale. Medco violated the revenue recognition principle because it never earned such revenues.
2. During the stock market bubble in 1999, EBITDA became the measurment of a company's financial health. The higher the EBITDA, the higher the earnings, and thus the stock price. Higher stock prices mean easier access to capital and a stronger financial picture—on paper. This also encourages Wall Street analysts to forecast increasing EBITDA for the future. So, Adelphia was able to boost its earnings on paper until the scheme fell apart.

THE NAVIGATOR

DEMONSTRATION PROBLEM 1

Presented below are a number of operational guidelines and practices that have developed over time.

Instructions

Identify the accounting assumption, accounting principle, or reporting constraint that most appropriately justifies these procedures and practices. Use only one item per description.

(a) The first note, "Summary of Significant Accounting Policies," presents information on the subclassification of plant assets and discusses the company's depreciation methods.

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(b) The local hamburger restaurant expenses all spatulas, french fry baskets, and other cooking utensils when purchased.

(c) Retailers recognize revenue at the point of sale.

(d) Green-Grow Landcape, Inc. includes an estimate of warranty expense in the year in which it sells its lawn mowers, which carry a 2-year warranty.

(e) Companies present sufficient financial information so that creditors and reasonably prudent investors will not be misled.

(f) Companies listed on U.S. stock exchanges report audited financial information annually and report unaudited information quarterly.

(g) Beach Resorts, Inc. does not record the 2004 value of $1.5 million for a piece of beachfront property it purchased in 1989 for $500,000.

(h) Restaurant Supplies, Inc. takes a $32,000 loss on a number of older ovens in its inventory; it paid the manufacturer $107,000 for them but can sell them for only $75,000.

(i) **Frito Lay** is a wholly owned subsidiary of **PepsiCo, Inc.**, and Frito Lay's operating results and financial condition are included in the consolidated financial statements of PepsiCo. (Do not use full disclosure.)

ACTION PLAN

Remember that:

- The four principles are cost, revenue recognition, matching, and full disclosure.
- The two constraints are materiality and conservatism.
- Full disclosure relates generally to the item; materiality to the amount.

SOLUTION TO DEMONSTRATION PROBLEM 1

(a) Full disclosure principle
(b) Materiality constraint
(c) Revenue recognition principle
(d) Matching principle
(e) Full disclosure principle
(f) Time period assumption
(g) Cost principle
(h) Conservatism constraint
(i) Economic entity assumption

THE NAVIGATOR

DEMONSTRATION PROBLEM 2

Presented below is financial information related to Notting Hill Hotel Corporation for the year 2004. All balances are ending balances unless stated otherwise.

Accounts payable	$ 868,000
Accounts receivable	700,000
Accumulated depreciation—equipment	100,000
Administrative expenses	280,000
Bonds payable	1,600,000
Cash	800,000
Common stock	500,000
Cost of goods sold	1,600,000
Dividends	60,000
Equipment	1,100,000
Income tax expense	83,000
Interest expense	60,000
Interest revenue	120,000
Inventories	500,000
Loss on the sale of equipment	35,000
Marketable (trading) securities	400,000
Net sales	2,400,000
Notes payable (short-term)	800,000
Other long-term debt	387,000
Patents and other intangibles	900,000
Prepaid expenses	200,000
Retained earnings (January 1, 2004)	80,000
Selling expenses	220,000
Taxes payable	83,000

Notting Hill Hotel Corporation had 88,000 shares of common stock outstanding for the entire year.

ACTION PLAN

- Remember that income tax expense is reported immediately after "Income before income taxes" for both a multiple-step and single-step income statement.
- Report earnings per share on both a multiple-step and a single-step income statement.
- Disclose net income and dividends on a retained earnings statement.
- Refer to Chapter 5, p. 166, for an example of a classified balance sheet.

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Instructions

(a) Prepare a multiple-step income statement.

(b) Prepare a single-step income statement.

(c) Prepare a retained earnings statement.

(d) Prepare a classified balance sheet.

(e) Compute the following balance sheet relationships.
(1) Current ratio
(2) The amount of working capital
(3) Debt to total assets ratio
What insights do these relationships provide to the reader of the financial statements?

(f) Compute three measures of profitability from the income statement and balance sheet information. What insights do these relationships provide to the reader of the financial statements?

SOLUTION TO DEMONSTRATION PROBLEM 2

(a) Multiple-step income statement

NOTTING HILL HOTEL CORPORATION
Income Statement
For the Year Ended December 31, 2004

Net sales		$2,400,000
Cost of goods sold		1,600,000
Gross profit		800,000
Selling expenses	$220,000	
Administrative expenses	280,000	500,000
Income from operations		300,000
Other revenues and gains		
Interest revenue		120,000
Other expenses and losses		
Loss on sale of equipment	35,000	
Interest expense	60,000	95,000
Income before income taxes		325,000
Income tax expense		83,000
Net income		$ 242,000
Earnings per share		$2.75

(b) Single-step income statement

NOTTING HILL HOTEL CORPORATION
Income Statement
For the Year Ended December 31, 2004

Revenues		
Net sales		$2,400,000
Interest revenue		120,000
Total revenues		2,520,000
Expenses		
Cost of goods sold	$1,600,000	
Selling expenses	220,000	
Administrative expenses	280,000	
Interest expense	60,000	
Loss on the sale of equipment	35,000	2,195,000
Income before income taxes		325,000
Income tax expense		83,000
Net income		$ 242,000
Earnings per share		$2.75

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(c) Retained earnings statement

NOTTING HILL HOTEL CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2004

Retained earnings, January 1	$ 80,000
Add: Net income	242,000
	322,000
Less: Dividends	60,000
Retained earnings, December 31	$262,000

(d) Classified balance sheet

NOTTING HILL HOTEL CORPORATION
Balance Sheet
December 31, 2004

Current assets		
Cash		$ 800,000
Marketable (trading) securities		400,000
Accounts receivable		700,000
Inventories		500,000
Prepaid expenses		200,000
Total current assets		2,600,000
Property, plant, and equipment		
Equipment	$1,100,000	
Less: Accumulated depreciation	100,000	1,000,000
Intangible assets		
Patents and other intangible assets		900,000
Total assets		$4,500,000
Current liabilities		
Notes payable		$ 800,000
Accounts payable		868,000
Taxes payable		83,000
Total current liabilities		1,751,000
Long-term liabilities		
Bonds payable	$1,600,000	
Other long-term debt	387,000	1,987,000
Total liabilities		3,738,000
Stockholders' equity		
Common stock	500,000	
Retained earnings	262,000	762,000
Total liabilities and stockholders' equity		$4,500,000

(e) Balance sheet relationships

(1) $$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$2,600,000}{\$1,751,000} = 1.48{:}1$$

(2) Working capital = Current assets − Current liabilities

Current assets	$2,600,000
Current liabilities	1,751,000
Working capital	$ 849,000

(3) $$\text{Debt to total assets} = \frac{\text{Debt}}{\text{Total assets}} = \frac{\$3,738,000}{\$4,500,000} = 83.07\%$$

Notting Hill's liquidity and solvency are of mixed quality. The current ratio is satisfactory, with its working capital healthy (i.e. current assets well in excess of current liabilities). However, its debt to total assets, at well over 80 percent, is too high. Given the company's relatively low profitability (see next page), its creditors might be concerned.

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(f) Profitability relationships

$$\text{Profit margin percentage} = \frac{\text{Net income}}{\text{Net sales}} = \frac{\$242{,}000}{\$2{,}400{,}000} = 10.08\%$$

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Total assets}} = \frac{\$242{,}000}{\$4{,}500{,}000} = 5.38\%$$

$$\text{Return on common stockholders' equity} = \frac{\text{Net income}}{\text{Common stockholders' equity}} = \frac{\$242{,}000}{\$762{,}000} = 31.76\%$$

THE NAVIGATOR

The profit margin percentage (return on sales) for Notting Hill seems adequate. Given the company's large asset base, however, it should probably generate a higher profit. The company's overall financial picture, then, could be better.

SUMMARY OF STUDY OBJECTIVES

1. ***Explain the meaning of generally accepted accounting principles and identify the key items of the conceptual framework.*** Generally accepted accounting principles are a set of rules and practices that are recognized as a general guide for financial reporting purposes. Generally accepted means that these principles must have "substantial authoritative support." The key items of the conceptual framework are: (1) objectives of financial reporting; (2) qualitative characteristics of accounting information; (3) elements of financial statements; and (4) operating guidelines (assumptions, principles, and constraints).

2. ***Describe the basic objectives of financial reporting.*** The basic objectives of financial reporting are to provide information that is (1) useful to those making investment and credit decisions; (2) helpful in assessing future cash flows; and (3) helpful in identifying economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims.

3. ***Discuss the qualitative characteristics of accounting information and elements of financial statements.*** To be judged useful, information should possess the following qualitative characteristics: relevance, reliability, comparability, and consistency. The elements of financial statements are a set of definitions that can be used to describe the basic terms used in accounting.

4. ***Identify the basic assumptions used by accountants.*** The major assumptions are: monetary unit, economic entity, time period, and going concern.

5. ***Identify the basic principles of accounting.*** The major principles are revenue recognition, matching, full disclosure, and cost.

6. ***Identify the two constraints in accounting.*** The major constraints are materiality and conservatism.

7. ***Understand and analyze classified financial statements.*** We presented the classified balance sheets and classified income statement in this chapter. In particular, income taxes and earnings per share are highlighted and discussed. Three items used to analyze the balance sheet are the current ratio, working capital, and debt to total assets. Earnings per share, profit margin percentage (return on sales), return on assets, and return on common stockholders' equity are used to analyze profitability.

8. ***Explain the accounting principles used in international operations.*** There are few recognized worldwide accounting standards. The International Accounting Standards Committee (IASC), of which the United States is a member, is working to obtain conformity in international accounting practices.

9. ***Identify the various systems of accounting procedures used in the hospitality industry***. There are currently three systems: The Uniform System of Accounts for the Lodging Industry, The Uniform System of Accounts for Restaurants, and The Uniform System of Financial Reporting for Clubs. Each has a long history, and their purpose is to provide users of financial information with comparable data and meaningful analyses.

10. ***Understand accounting and financial management in a hotel.*** Proper accounting and financial management of a hotel is crucial to its success. The chief accounting officer is known as the controller. The controller is part of the hotel's executive committee, which includes the general manager and all department heads. The controller interacts with all the department heads, assisting and consulting with them on all financial matters so each department head makes sound decisions.

11. ***Understand accounting and financial management in a foodservice operation and a club.*** The controller of a foodservice operation focuses on food, beverage, and labor costs. Food and beverage cost analyses are of particular importance due to the amount of money spent and the perishable nature of the products. The club industry is unique in that its customers are all members of the club. Members pay dues to the club and in return have a decision-making role in club operations. Members also spend money on food and beverage, merchandising, and other amenities. Therefore, a club controller must account for revenues by looking at different cost centers such as golf, tennis, spa, and food and beverages to provide solid information for management.

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GLOSSARY

American Hotel and Lodging Association (AH&LA) A trade association whose members are mostly hotels and lodging properties in the United States (p. 57).

Club Managers Association of America (CMAA) A trade association whose members are mostly club managers in the United States (p. 56).

Comparability Ability to compare accounting information of different companies because they use the same accounting principles (p. 38).

Conceptual framework A coherent system of interrelated objectives and fundamentals that can lead to consistent standards (p. 37).

Conservatism The approach of choosing an accounting method when in doubt that will least likely overstate assets and net income (p. 46).

Consistency Use of the same accounting principles and methods from year to year within a company (p. 39).

Controller The department head of the accounting department who has to work with not only the employees in the accounting and business office, but with all department heads (p. 58).

Cost principle Accounting principle that assets should be recorded at their historical cost (p. 44).

Current ratio A measure that expresses the relationship of current assets to current liabilities by dividing current assets by current liabilities (p. 51).

Debt to total assets ratio Solvency measure that indicates the percentage of total assets provided by creditors; calculated as total debt divided by total assets (p. 54).

Earnings per share (EPS) The net income earned by each share of outstanding common stock (p. 50).

Economic entity assumption Accounting assumption that economic events can be identified with a particular unit of accountability (p. 41).

Elements of financial statements Definitions of basic terms used in accounting (p. 39).

Executive committee The executive committee is made up of all the department heads of a hotel. This group comes together for meetings to make decisions and ensure all information is relayed correctly (p. 58).

Full disclosure principle Accounting principle that circumstances and events that make a difference to financial statement users should be disclosed (p. 44).

General manager This person is the manager of the entire hotel. He or she manages the hotel through the various department heads (p. 57).

Generally accepted accounting principles (GAAP) A set of rules and practices, having substantial authoritative support, that are recognized as a general guide for financial reporting purposes (p. 36).

Going concern assumption The assumption that the enterprise will continue in operation long enough to carry out its existing objectives and commitments (p. 41).

Hospitality Financial and Technology Professionals (HFTP) A membership-based organization for financial and technology professionals. Its aim is to provide continuing education, resources, certifications, information sharing, and networking opportunities for its membership. It also produces the HITEC trade show; the largest technology trade show for the hospitality industry worldwide (p. 56).

International Accounting Standards Committee (IASC) An accounting organization whose purpose is to formulate and publish international accounting standards and to promote their acceptance worldwide (p. 55).

Matching principle Accounting principle that expenses should be matched with revenues in the period when efforts are expended to generate revenues (p. 42).

Materiality The constraint of determining if an item is important enough to likely influence the decision of a reasonably prudent investor or creditor (p. 46).

Monetary unit assumption Accounting assumption that only transaction data capable of being expressed in monetary terms should be included in accounting records (p. 41).

National Restaurant Association (NRA) A trade association whose members are mostly restaurateurs and restaurant corporations in the United States (p. 63).

Profit margin percentage Profitability measure that indicates the percentage of each dollar of sales that results in net income; calculated as net income divided by net sales. Also called *rate of return on sales* (p. 52).

Relevance The quality of information that indicates the information makes a difference in a decision (p. 38).

Reliability The quality of information that gives assurance that it is free of error and bias (p. 38).

Return on assets An overall measure of a company's profitability; calculated as net income divided by total assets (p. 53).

Return on common stockholders' equity Profitability measure that shows the rate of net income earned for each dollar of owners' investment; calculated as net income divided by common stockholders' equity (p. 53).

Revenue recognition principle Accounting principle that revenue should be recognized in the accounting period in which it is earned (generally at the point of sale) (p. 42).

Time period assumption Accounting assumption that the economic life of a business can be divided into artificial time periods (p. 41).

The Uniform System of Accounts for the Lodging Industry A system of accounting guidelines and procedures developed for the use of hotel and lodging properties (p. 56).

The Uniform System of Accounts for Restaurants A system of accounting guidelines and procedures developed for the use of hotel and lodging properties (p. 56).

The Uniform System of Financial Reporting for Clubs A system of accounting guidelines and procedures developed for the use of various types of clubs (p. 56).

Working capital The excess of current assets over current liabilities (p. 52).

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EXERCISES

Identify generally accepted accounting principles. (SO 1)

2-1 Indicate whether each of the following statements is true or false.

(a) ____ *Generally accepted* means that these principles must have "substantial authoritative support."
(b) ____ Substantial authoritative support for GAAP usually comes from two standard-setting bodies: the FASB and the IRS.
(c) ____ GAAP is a set of rules and practices established by the accounting profession to serve as a general guide for financial reporting purposes.

Identify items included in conceptual framework. (SO 1)

2-2 Indicate which of the following items is(are) included in the FASB's conceptual framework. (Use "Yes" or "No" to answer this question.)

(a) ____ Analysis of financial statement ratios.
(b) ____ Objectives of financial reporting.
(c) ____ Qualitative characteristics of accounting information.

Identify objectives of financial reporting. (SO 2)

2-3 According to the FASB's conceptual framework, which of the following are objectives of financial reporting? (Use "Yes" or "No" to answer this question.)

(a) ____ Provide information that is helpful in assessing past cash flows and stock prices.
(b) ____ Provide information that is useful to those making investment and credit decisions.
(c) ____ Provide information that identifies the economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims.

Identify operating guidelines. (SO 4, 5, 6)

2-4 Presented below are four concepts discussed in this chapter.

1. Time period assumption
2. Cost principle
3. Full disclosure principle
4. Conservatism

Match these concepts to the following accounting practices. Each number can be used only once.

(a) ____ Recording inventory at its purchase price.
(b) ____ Using notes and supplementary schedules in the financial statements.
(c) ____ Preparing financial statements on an annual basis.
(d) ____ Using the lower of cost or market method for inventory valuation.

Identify the assumption, principle, or constraint that has been violated. (SO 4, 5, 6)

2-5 A number of accounting reporting situations are described below.

1. Cuneo Company recognizes revenue at the end of the production cycle, but before sale. The price of the product, as well as the amount that can be sold, is not certain.
2. In preparing its financial statements, Diane Torres Company omitted information concerning its method of accounting for inventories.
3. Jan Way Corp. charges the entire premium on a two-year insurance policy to the first year.
4. Holloway Hospital Supply Corporation reports only current assets and current liabilities on its balance sheet. Property, plant, and equipment and bonds payable are reported as current assets and current liabilities, respectively. Liquidation of the company is unlikely.
5. Bagley Inc. is carrying inventory at its current market value of $100,000. Inventory had an original cost of $110,000.
6. Karen Allman Company is in its fifth year of operation and has yet to issue financial statements. (Do not use full disclosure principle.)
7. Jana Kingston Co. has inventory on hand that cost $400,000. Kingston Co. reports inventory on its balance sheet at its current market value of $425,000.
8. Susan Elbe, president of the Classic Music Company, bought a computer for her personal use. She paid for the computer by using company funds and debited the "Computers" account.

Instructions

For each of the above, list the assumption, principle, or constraint that has been violated, if any. List only one term for each case.

Identify the assumption, principle, or constraint that has been violated and prepare correct entries. (SO 4, 5, 6)

2-6 Presented below are some business transactions that occurred during 2004 for Sammy Sosa Company.

(a) Merchandise inventory with a cost of $208,000 is reported at its market value of $260,000. The following entry was made.

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Merchandise Inventory	52,000	
Gain		52,000

(b) Equipment worth $60,000 was acquired at a cost of $46,000 from a company that had water damage in a flood. The following entry was made.

Equipment	60,000	
Cash		46,000
Gain		14,000

(c) The president of Sammy Sosa Company, Charles Brieschke, purchased a truck for personal use and charged it to his expense account. The following entry was made.

Travel Expense	18,000	
Cash		18,000

(d) An electric pencil sharpener costing $50 is being depreciated over 5 years. The following entry was made.

Depreciation Expense—Pencil Sharpener	10	
Accumulated Depreciation—Pencil Sharpener		10

Instructions

In each of the situations above, identify the assumption, principle, or constraint that has been violated, if any. Discuss the appropriateness of the journal entries, and give the correct journal entry, if necessary.

2-7 Presented below are the assumptions, principles, and constraints discussed in this chapter.

Identify accounting assumptions, principles, and constraints. (SO 4, 5, 6)

1. Economic entity assumption
2. Going concern assumption
3. Monetary unit assumption
4. Time period assumption
5. Cost principle
6. Matching principle
7. Full disclosure principle
8. Revenue recognition principle
9. Materiality
10. Conservatism

Instructions

Identify by number the accounting assumption, principle, or constraint that describes each situation below. Do not use a number more than once.

(a) Explains why plant assets are not reported at liquidation value. (Do not use historical cost principle.)
(b) Indicates that personal and business record keeping should be separately maintained.
(c) Ensures that all relevant financial information is reported.
(d) Assumes that the dollar is the "measuring stick" used to report on financial performance.
(e) Requires that the operational guidelines be followed for all significant items.
(f) Separates financial information into time periods for reporting purpose.
(g) Requires recognition of expenses in the same period as related revenues.
(h) Indicates that market value changes subsequent to purchase are not recorded in the accounts.

2-8 Presented below are the assumptions, principles, and constraints used in this chapter.

Identify accounting assumptions, principles, and constraints. (SO 4, 5, 6)

1. Economic entity assumption
2. Going concern assumption
3. Monetary unit assumption
4. Time period assumption
5. Full disclosure principle
6. Revenue recognition principle
7. Matching principle
8. Cost principle
9. Materiality
10. Conservatism

Identify by number the accounting assumption, principle, or constraint that matches each description below. Do not use a number more than once.

(a) Repair tools are expensed when purchased. (Do not use conservatism.)
(b) Allocates expenses to revenues in proper period.
(c) Assumes that the dollar is the measuring stick used to report financial information.
(d) Separates financial information into time periods for reporting purposes.
(e) Market value changes subsequent to purchase are not recorded in the accounts. (Do not use revenue recognition principle.)

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(f) Indicates that personal and business record keeping should be separately maintained.
(g) Ensures that all relevant financial information is reported.
(h) Lower of cost or market is used to value inventories.

Analyze transactions to identify accounting principle or assumption violated, and prepare correct entries. (SO 4, 5)

2-9 Dye and Zaur are accountants for SuperResorts. They disagree over the following transactions that occurred during the calendar year 2004.

1. Dye suggests that equipment should be reported on the balance sheet at its liquidation value, which is $15,000 less than its cost.
2. SuperResorts bought a custom-made piece of equipment for $24,000. This equipment has a useful life of 6 years. SuperResorts depreciates equipment using the straight-line method. "Since the equipment is custom-made, it will have no resale value. Therefore, it shouldn't be depreciated but instead should be expensed immediately," argues Dye. "Besides, it provides for lower net income."
3. Depreciation for the year was $18,000. Since net income is expected to be lower this year, Dye suggests deferring depreciation to a year when there is more net income.
4. Land costing $60,000 was appraised at $90,000. Dye suggests the following journal entry.

Land	30,000	
Gain on Appreciation of Land		30,000

5. SuperResorts purchased equipment for $30,000 at a going-out-of-business sale. The equipment was worth $45,000. Dye believes that the following entry should be made.

Equipment	45,000	
Cash		30,000
Gain		15,000

Zaur disagrees with Dye on each of the above situations.

Instructions

For each transaction, indicate why Zaur disagrees. Identify the accounting principle or assumption that Dye would be violating if his suggestions were used. Prepare the correct journal entry for each transaction, if any.

Determine the appropriateness of journal entries in terms of generally accepted accounting principles or assumptions. (SO 4, 5)

2-10 Presented below are a number of business transactions that occurred during the current year for Chavez, Inc.

1. Because the general level of prices increased during the current year, Chavez, Inc. determined that there was a $10,000 understatement of depreciation expense on its equipment and decided to record it in its accounts. The following entry was made.

Depreciation Expense	10,000	
Accumulated Depreciation		10,000

2. Because of a "flood sale," equipment obviously worth $250,000 was acquired at a cost of $150,000. The following entry was made.

Equipment	250,000	
Cash		150,000
Gain on Purchase of Equipment		100,000

3. The president of Chavez, Inc. used his expense account to purchase a new Saab 9000 solely for personal use. The following entry was made.

Miscellaneous Expense	34,000	
Cash		34,000

4. An order for $30,000 has been received from a customer for products on hand. This order is to be shipped on January 9 next year. The following entry was made.

Accounts Receivable	30,000	
Sales		30,000

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5. Materials were purchased on March 31 for $65,000. This amount was entered in the Inventory account. On December 31, the materials would have cost $85,000, so the following entry was made.

Inventory	20,000	
Gain on Inventories		20,000

Instructions

In each situation, discuss the appropriateness of the journal entries in terms of generally accepted accounting principles.

EXPLORING THE WEB

2-11 The **Financial Accounting Standards Board (FASB)** is a private organization established to improve accounting standards and financial reporting. The FASB conducts extensive research before issuing a "Statement of Financial Accounting Standards," which represents an authoritative expression of generally accepted accounting principles.

Address: **www.accounting.rutgers.edu/raw**

Steps

1. Choose **FASB**.
2. Choose **FASB Facts**.

Instructions

Answer the following questions.

(a) What is the mission of the FASB?
(b) How are topics added to the FASB technical agenda?
(c) What characteristics make the FASB's procedures an "open" decision-making process?

ETHICS CASE

2-12 When the Financial Accounting Standards Board issues new standards, the required implementation date is usually 12 months or more from the date of issuance, with early implementation encouraged. Richard Keith, accountant at Manchester Corporation, discusses with his financial vice president the need for early implementation of a recently issued standard that would result in a much fairer presentation of the company's financial condition and earnings. When the financial vice president determines that early implementation of the standard will adversely affect reported net income for the year, he strongly discourages Richard from implementing the standard until it is required.

Instructions

(a) Who are the stakeholders in this situation?
(b) What, if any, are the ethical considerations in this situation?
(c) What does Richard have to gain by advocating early implementation? Who might be affected by the decision against early implementation?

Answer to Hilton Review It Question 2, p. 40

The Report of Independent Public Accountants indicates that **Hilton's** financial statements (balance sheet, statement of operations, shareholders' investment, and cash flows) are presented fairly, in accordance with generally accepted accounting principles.

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.