



This is “What Is Financial Accounting, and Why Is It Important?”, chapter 1 from the book [Business Accounting \(index.html\)](#) (v. 2.0).

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Chapter 1

What Is Financial Accounting, and Why Is It Important?

Video Clip

[\(click to see video\)](#)

In this video, Professor Joe Hoyle introduces the essential points covered in [Chapter 1 "What Is Financial Accounting, and Why Is It Important?"](#).

1.1 Making Good Financial Decisions about an Organization

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Define “financial accounting.”
2. Understand the connection between financial accounting and the communication of information about an organization.
3. Explain the importance of gaining an understanding of financial accounting.
4. List decisions that an individual might make about an organization.
5. Differentiate between financial accounting and managerial accounting.
6. Provide reasons for individuals to study the financial accounting information supplied by their employers.

Financial Accounting and Information

Question: In the June 30, 2011, edition of The Wall Street Journal, numerous headlines described the recent activities of various business organizations. Here are just a few:

“TMX and LSE Give Up on Planned Merger”

“Ally Financial Faces Charge for Mortgage Losses”

“HomeAway Jumps 49% in Debut”

“Ad-Seller Acquiring Myspace for a Song”

Millions of individuals around the world read such stories each day with rapt interest. From teen-agers to elderly billionaires, this type of information is analyzed obsessively. How are these people able to understand all the data and details being provided? For most, the secret is straightforward: a strong knowledge of financial accounting.

This textbook provides an introduction to financial accounting. A logical place to begin such an exploration is to ask the obvious question: What is financial accounting?

Answer: In simplest terms, **financial accounting**¹ is the communication of information about a business or other type of organization (such as a charity or government) so that individuals can assess its financial health and future prospects. No single word is more relevant to financial accounting than “information.” Whether it is gathering monetary information about a specific organization, putting that information into a format designed to enhance communication, or analyzing the information that is conveyed, financial accounting is intertwined with information.

In today’s world, information is king. Financial accounting provides the rules and structure for the conveyance of financial information about businesses (and other organizations) to maximize clarity and understanding. Although a wide array of organizations present financial information to interested parties, this book primarily focuses on the reporting of businesses because that is where the widest use of financial accounting occurs.

organization → reports information based on the principles of financial accounting
→ interested individuals assess financial health and future prospects

At any point in time, some businesses are poised to prosper while others teeter on the verge of failure. Many people want to be able to evaluate the degree of success achieved to date by a particular organization as well as its prospects for the future. They seek information and the knowledge that comes from understanding that information. How well did **The Coca Cola Company** do last year, and how well should this business do in the coming year? Those are simple questions to ask, but the answers can make the difference between earning millions and losing millions.

Financial accounting provides data that these individuals need and want.

Financial Accounting and Wise Decision Making

Question: Every semester, most college students are enrolled in several courses as well as participate in numerous outside activities. All of these compete for the hours that make up each person’s day. Why should a student invest valuable time to learn the principles of financial accounting? Why should anyone be concerned with the information communicated about an organization? What makes financial accounting important?

1. The communication of financial information about a business or other type of organization to external audiences to help them assess its financial health and future prospects.

Answer: Many possible benefits can be gained from acquiring a strong knowledge of financial accounting because it provides the accepted methods for communicating relevant information about an organization. In this book, justification for the serious study that is required to master this subject matter is simple and straightforward. Obtaining a working knowledge of financial accounting and its underlying principles enables a person to understand the information conveyed about an organization so that better decisions can be made.

Around the world each day, millions of individuals make critical judgments about the businesses and other organizations they encounter. Developing the ability to analyze financial information and then making use of that knowledge to arrive at sound decisions can be critically important. Whether an organization is as gigantic as **Walmart** or as tiny as a local convenience store, individuals have many, varied reasons for studying the information that is available.

As just a single example, a recent college graduate looking at full-time employment opportunities might want to determine the probability that Company A will have a brighter economic future than Company B. Although such decisions can never be correct 100 percent of the time, knowledge of financial accounting and the information being communicated greatly increases the likelihood of success. As Kofi Annan, former secretary-general of the United Nations, has said, “Knowledge is power. Information is liberating.” See <http://www.deepsky.com/~madmagic/kofi.html>.

Thus, the ultimate purpose of this book is to provide students with a rich understanding of the rules and nuances of financial accounting so they can evaluate available information about organizations and then make good decisions. In the world of business, most successful individuals have developed this ability and are able to use it to achieve their investing and career objectives.

Common Decisions about Organizations

Question: Knowledge of financial accounting assists individuals in making informed decisions about businesses and other organizations. What kinds of evaluations are typically made? For example, assume that a former student—one who recently graduated from college—has been assigned the task of analyzing financial data provided by the Acme Company. What real-life decisions could a person be facing where an understanding of financial accounting would be beneficial?

Answer: The number of possible judgments that an individual might need to make about a business or other organization is close to unlimited. However, many of these decisions deal with the current financial health and prospects for future success. In order to analyze available data to make such assessments, a working knowledge of financial accounting is invaluable. The more in-depth the understanding is of those principles, the more likely the person will be able to use the information to arrive at the best possible choices. Common examples include the following:

- Should a bank loan money to the Acme Company? The college graduate might be employed by a bank to work in its corporate lending department. Assume, for example, that the Acme Company is a local business that has applied to the bank for a large loan so that it can expand. The graduate has been instructed by bank management to prepare an assessment of Acme to determine if it is likely to be financially healthy in the future so that it will be able to repay the borrowed money when due. A correct decision to provide the loan eventually earns a profit for the bank because Acme will be required to pay an extra amount (known as **interest**²) on the money borrowed. Conversely, an incorrect analysis of the information could lead to a substantial loss if the loan is granted and Acme is unable to fulfill its obligation. Bank officials must weigh the potential for profit against the risk of loss. That is a daily challenge in virtually all businesses. The former student's career with the bank might depend on the ability to analyze financial accounting data and then make appropriate choices about the actions to be taken. Should a loan be made to this company?
- Should another business make sales on credit to the Acme Company? The college graduate might hold a job as a credit analyst for a manufacturing company that sells its products to retail stores. Assume that Acme is a relatively new retailer that wants to buy goods (inventory) on credit from this manufacturer to sell in its stores. The former student must judge whether to permit Acme to buy merchandise now but wait until later to remit the money. If payments are received on a timely basis, the manufacturer will have found a new outlet for its merchandise. Profits will likely increase. Unfortunately, Acme could also make expensive purchases but then be unable to make payment, creating significant losses for the manufacturer. Again, the possibility of profit must be measured against the chance for loss.
- Should an individual invest money to become one of the owners of the Acme Company? The college graduate might be employed by a firm that provides financial advice to its clients. Assume that the firm is presently considering whether to recommend acquisition of ownership shares of Acme as a good investment strategy. The former student has been assigned to gather and evaluate relevant financial information as

2. The charge for using money over time, often associated with long-term loans; even if not specifically mentioned in the debt agreement, financial accounting rules require it to be computed and reported based on a reasonable rate.

a basis for this decision. If Acme is poised to become larger and more profitable, its ownership shares will likely rise in value over time, earning money for the firm's clients. Conversely, if the prospects for Acme appear to be dim, the value of these shares might start to drop (possibly precipitously) so that the investment firm should avoid suggesting the purchase of an ownership interest in this business.

Success in life—especially in business—frequently results from being able to make appropriate decisions. Many economic choices, such as those described earlier, depend on a person's ability to understand and make use of financial information about organizations. That financial information is produced and presented in accordance with the rules and principles underlying financial accounting.

TEST YOURSELF

Question:

James Esposito is a college student who has just completed a class in financial accounting. He earned a good grade and wants to make use of his knowledge. He wants to invest \$10,000 that he recently inherited from a distant uncle. In which of the following decisions is Esposito most likely to have used his understanding of financial accounting?

- a. He decides to deposit the money in a bank to earn interest.
- b. He decides to buy ownership shares in **Microsoft Corporation** in hopes that they will appreciate in value.
- c. He decides to trade in his old car and buy a new one that uses less gasoline.
- d. He decides to buy a new computer so that he can make money by typing papers for his classmates.

Answer:

The correct answer is choice b: He decides to buy ownership shares in **Microsoft Corporation** in hopes that they will appreciate in value.

Explanation:

All of these are potentially good economic decisions. However, financial accounting focuses on conveying data to help reflect the financial health and prospects of organizations. His decision to buy ownership shares of **Microsoft** rather than any other company indicates that he believes that **Microsoft** is poised to grow and prosper. This decision is exactly the type that investors around the world make each day with the use of their knowledge of financial accounting.

Financial Accounting versus Managerial Accounting

Question: A great number of possible decisions could be addressed in connection with any business. Is an understanding of financial accounting relevant to all decisions made about an organization? What about the following?

- *Should a business buy a building to serve as its new headquarters or rent a facility instead?*

- *What price should a data processing company charge customers for its services?*
- *Should advertisements to alert the public about a new product be carried on the Internet or on television?*

Answer: Decisions such as these three are extremely important for the success of any organization. However, these examples are not made about the reporting organization. Rather, they are made within the organization in connection with some element of its operations.

The general term “accounting” refers to the communication of financial information for decision-making purposes. Accounting is then further subdivided into (a) financial accounting and (b) **managerial accounting**³. Tax accounting is another distinct branch of accounting. It is less focused on decision making and more on providing information needed by a business to comply with all government rules and regulations. Even in tax accounting, though, decision making is important as businesses seek to take all possible legal actions to minimize tax payments. Financial accounting is the subject explored in this textbook. It focuses on conveying relevant data (primarily to external parties) about an organization (such as **Motorola Mobility** or **Starbucks**) as a whole so that wise decisions can be made. Thus, questions such as the following all fall within the discussion of financial accounting:

- Do we loan money to the Acme Company?
- Do we sell on credit to the Acme Company?
- Do we recommend that our clients buy the ownership shares of the Acme Company?

These decisions pertain to an overall evaluation of the financial health and future prospects of the Acme Company.

Managerial accounting is the subject of other books and other courses. This second branch of accounting refers to the communication of information within an organization so that internal decisions (such as whether to buy or rent a building) can be made in an appropriate manner. Individuals studying an organization as a whole have different goals than do internal parties making operational decisions. Thus, many unique characteristics have developed in connection with each of these two branches of accounting. Financial accounting and managerial accounting have evolved independently over the decades to address the specific needs of the users

3. The communication of financial information within an organization so internal decisions can be made in an appropriate manner.

being served and the decisions being made. This textbook is designed to explain those attributes that are fundamental to attaining a useable understanding of financial accounting.

It is not that one of these areas of accounting is more useful or more important than the other. Financial accounting and managerial accounting have simply been created to achieve different objectives. They both do their jobs well, but they do not have the same jobs.

TEST YOURSELF

Question:

Janet Wineston is vice president of the State Bank of Main Street. Here are four decisions that she made at her job today. Which of these decisions was likely to have required her to make use of her knowledge of financial accounting?

- a. She gave one of the tellers who works at the bank a pay raise.
- b. She hired an advertising consultant to produce a television commercial for the bank.
- c. She granted a \$300,000 loan to one company but not another.
- d. She decided on the rate of interest that would be paid to customers on a new type of savings account.

Answer:

The correct answer is choice c: She granted a \$300,000 loan to one company but not another.

Explanation:

Financial accounting focuses on decisions about organizations. When money was loaned to one company but not the other, Wineston was making decisions about both. She must have viewed one as more financially healthy than the other. Her other three decisions all relate to internal operations. Accounting information can certainly help in arriving at proper choices for these three, but it is managerial accounting that is designed to produce the needed data for such decisions.

Financial Accounting Information and Company Employees

Question: Financial accounting refers to the conveyance of information about an organization as a whole and is most frequently distributed to assist outside decision makers. Does a person who is employed by an organization care about the financial accounting data that is reported? Why should an employee in the marketing or personnel department of the Acme Company be interested in the financial information that this business generates and distributes?

Answer: Financial accounting is designed to portray the overall financial condition and prospects of an organization. Virtually every employee should be interested in studying that information to judge future employment prospects. A business that is doing well will possibly award larger pay raises or perhaps significant end-of-year cash bonuses. A financially healthy organization can afford to hire new employees, buy additional equipment, or pursue major new initiatives. Conversely, when a business is struggling and prospects are dim, employees might anticipate layoffs, pay cuts, or reductions in resources.

Thus, although financial accounting information is directed to outside decision makers, employees should be keenly interested in the financial health of their own organization. No one wants to be clueless as to whether their employer is headed for prosperity or bankruptcy. In reality, employees are often the most avid readers of the financial accounting information distributed by employers because the results can have such an immediate and direct impact on their jobs and, hence, their lives.

KEY TAKEAWAY

Financial accounting encompasses the rules and procedures covering the conveyance of monetary information to describe a business or other organization. Individuals who attain a sufficient level of knowledge of financial accounting can then utilize this information to make decisions based on the organization's perceived financial health and future prospects. Such decisions might include assessing employment potential, lending money, granting credit, and buying or selling ownership shares. However, financial accounting does not address issues that are purely of an internal nature, such as whether an organization should buy or lease equipment or the level of pay raises. Information to guide such internal decisions is generated according to managerial accounting rules and procedures that are introduced in other books and courses. Although financial accounting is not directed toward the inner workings of an organization, most employees are interested in the resulting information because it helps them assess the future of their employer.

1.2 Incorporation and the Trading of Capital Shares

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Define incorporation.
2. Explain the popularity of investing in the capital stock of a corporation.
3. Discuss the necessity and purpose of a board of directors.
4. List the potential benefits gained from acquiring capital stock.

4. Legal process by which owners of an organization apply to a state government to have it identified as an entity legally separate from its owners (a corporation); corporations are the legal form of most businesses of any size in the United States.
5. An organization that has been formally recognized by the state government as a separate legal entity so that it can sell ownership shares to raise money for capital expenditures and operations.
6. An unincorporated business created, owned, and operated by a single individual; the business is not legally separate from its owner.
7. An unincorporated business created, owned, and operated by more than one individual; the business is not legally separate from its owners.
8. Individuals or organizations that hold the ownership shares of capital stock of a corporation; same as shareholders.
9. Individuals or organizations that hold the ownership shares of capital stock of a corporation; same as stockholders.

The Ownership Shares of an Incorporated Business

*Question: In discussing possible decisions that could be made about a business organization, ownership shares were mentioned. Virtually every day, on television, in newspapers, or on the Internet, mention is made that the shares of one company or another have gone up or down in price because of trading on one of the stock markets. Why does a person acquire ownership shares of a business such as **Capital One** or **Intel**?*

Answer: In the United States, as well as in many other countries, owners of a business can apply to the state government to become identified as an entity legally set apart from its owners. This process is referred to as **incorporation**⁴. Therefore, a **corporation**⁵ is an organization that has been formally recognized by the state government as a separate legal entity that can act independently of its owners. A business that has not been incorporated is either a **sole proprietorship**⁶ (one owner) or a **partnership**⁷ (more than one owner). These businesses are not separate from their ownership.

As will be discussed in detail in a later chapter, several advantages are gained from incorporation. One is especially important in connection with the study of financial accounting. A corporation has the ability to obtain monetary resources by selling (also known as issuing) capital shares that allow investors to become owners. They are then known as **stockholders**⁸ or **shareholders**⁹.

Millions of corporations operate in the United States. **The Walt Disney Company** and **General Electric** are just two well-known examples of corporations. They exist as legal entities completely distinct from the multitude of individuals and organizations that possess their ownership shares (also known as equity or **capital stock**¹⁰).

Any investor who acquires one or more shares of the capital stock of a corporation becomes an owner and has all of the rights that are specified by the state government or on the stock certificate. The number of shares and owners can be staggering. At the end of 2010, stockholders held over 2.3 billion shares of **The Coca-Cola Company**. Thus, possession of one share of the capital stock of **The Coca-Cola Company** provided a person with approximately a 1/2,300,000,000th part of the ownership.

One of the great advantages of incorporation is the ease by which most capital stock can be exchanged. For most companies, investors are able to buy or sell ownership shares on stock exchanges in a matter of moments. In contrast, sole proprietorships and partnerships rarely sell capital shares. Without the separation provided by incorporation, a clear distinction between owner and business does not exist. For example, debts incurred by a business that is a sole proprietorship or partnership may ultimately have to be satisfied by the owner personally. Thus, individuals tend to avoid making investments in unincorporated businesses unless they can be involved directly in the management. However, partnerships and sole proprietorships still remain popular because they are easy to create and offer possible income tax benefits as will be described in a later chapter.

If traded on a stock exchange, shares of the capital stock of a corporation continually go up and down in value based on myriad factors, including the perceived financial health and future prospects of the organization. As an example, during trading on July 1, 2011, the price of an ownership share of **Intel** rose by \$0.37 to \$22.53, while a share of **Capital One** went up by \$0.98 to \$52.65.

10. Ownership (equity) shares of stock in a corporation that are issued to raise monetary financing for capital expenditures and operations.

11. Organized stock market that efficiently matches buyers and sellers of capital stock at a mutually agreed-upon price allowing ownership in companies to change hands easily. The New York Stock Exchange is the largest stock exchange in the world followed by NASDAQ, the London Stock Exchange, the Tokyo Stock Exchange, and the Shanghai Stock Exchange.

For countless individuals and groups around the world, the most popular method of investment is through the purchase and sell of these capital shares of corporate ownership. Although many other types of investment opportunities are available (such as the acquisition of gold or land), few come close to evoking the level of interest of capital stock. The most prevalent form of capital stock is common stock so that these two terms have come to be used somewhat interchangeably. As will be discussed in a later chapter, the capital stock of some corporations is made up of both common stock and preferred stock. On the **New York Stock Exchange**¹¹ alone, billions of shares are bought and sold every business day at a wide range of prices.

As of June 30, 2011, an ownership share of **Sprint Nextel** was trading for \$5.39, while a single share of **Berkshire Hathaway** sold for \$116,105.00.

TEST YOURSELF

Question:

Ray Nesbitt owns a store in his hometown of Charlotte, North Carolina, that sells food and a variety of other goods. He has always operated this store as a sole proprietorship because he was the only owner. Recently, he went to his lawyer and began the legal process of turning his business into a corporation. Which of the following is the most likely reason for this action?

- a. He can sell a wider variety of goods as a corporation.
- b. He has plans to build a second, and maybe a third, store in the area.
- c. The store has reached a size where incorporation has become mandatory.
- d. He hopes his son will one day decide to become a member of the management.

Answer:

The correct answer is choice b: He has plans to build a second, and maybe a third, store in the area.

Explanation:

One of the most important reasons to incorporate a business is that additional sources of capital can be tapped by issuing stock. Nesbitt may be planning to get the money needed to build the new stores by encouraging others to acquire stock and become owners. There is no size limit for incorporation, and the decision has little or nothing to do with operations. Neither the selection of goods nor the members of the management team is affected by the legal form of the business.

The Operational Structure of a Corporation

Question: The owners of most small corporations can operate their businesses effectively as both stockholders and managers. For example, two friends might each own half of the capital stock of a bakery or a retail clothing store. Those individuals probably work together to manage this business on a day-to-day basis.

Because of the number of people who can be involved, large corporations offer a significantly different challenge. How do millions of investors possessing billions of capital shares of a corporation ever serve in any reasonable capacity as the owners and managers of that business?

Answer: Obviously, a great many corporations like **The Coca-Cola Company** have an enormous quantity of capital shares held by tens of thousands of investors. Virtually none of these owners can expect to have any impact on the daily operations of the business. A different operational structure is needed. In a vast number of such organizations, stockholders vote to elect a representative group to oversee operations. This body—called the **board of directors**¹²—is made up of approximately ten to twenty-five knowledgeable individuals. A story produced by National Public Radio on the roles played by a board of directors can be found at <http://www.npr.org/templates/story/story.php?storyId=105576374>.

As shown in **Figure 1.1 "Company Operational Structure"**, the board of directors hires the members of management who run the business on a daily basis. The board then meets periodically (often quarterly) to review operating, investing, and financing results as well as to approve strategic policy initiatives.

Figure 1.1 Company Operational Structure

Ownership	Each capital share is the equivalent of one unit of ownership.
Board of Directors	Elected by shareholders to hire and oversee the management of the company and make policy decisions.
Management	Officials such as the president, the chief financial officer, and the director of marketing who are in charge of daily operations.
Employees	All individuals who work for a company who are not deemed to be members of the management.

12. A group that oversees the management of a corporation; the members are voted to this position by stockholders; it hires the management to run the company on a daily basis and then meets periodically to review operating, investing, and financing results and also to approve policy and strategy.

Occasionally, the original founders of a business (or their descendants) continue to hold enough shares to influence or actually control operating and other significant decisions of a business. Or wealthy outside investors might acquire enough shares to gain this same level of power. Such owners have genuine authority within the corporation. Even that degree of control, though, is normally carried out through

membership on the board of directors. For example, at the end of 2010, the **Ford Motor Company** had fifteen members on its board of directors, three of whom were named Ford. Except in rare circumstances, the hierarchy of owners, board of directors, management, and employees remains intact. Thus, most stockholders are not involved with the operating decisions of any large corporation.

Predicting the Appreciation of Capital Stock Values

*Question: The acquisition of capital shares of a corporation is an extremely popular investment strategy for a wide range of the population. A buyer becomes one of the owners of the business. Why spend money in this way especially since very few stockholders can ever hope to hold enough shares to participate in managing or influencing operations? Ownership shares sometimes cost small amounts but can also require hundreds if not thousands of dollars. What is the potential benefit of buying capital stock issued by a business organization such as **PepsiCo** or **Chevron**?*

Answer: Capital shares of thousands of corporations trade each day on markets around the world such as the New York Stock Exchange or **NASDAQ (National Association of Securities Dealers Automated Quotations)**¹³. One party is looking to sell shares whereas another is seeking shares to buy. Stock markets match up these buyers and sellers so that a mutually agreed-upon price can be negotiated. This bargaining process allows the ownership interests of these companies to change hands with relative ease.

When investors believe a business is financially healthy and its future is bright, they expect prosperity and growth to continue. If that happens, the negotiated price for the capital shares of the corporation should rise over time. Investors around the world attempt to anticipate such movements in order to buy the stock at a low price and sell later at a higher one. Conversely, if predictions are not optimistic, then a business's share price is likely to drop so that owners will experience losses in the value of their investments.

Financial accounting information plays an invaluable role in this market process as millions of investors attempt to assess the financial condition and prospects of various business organizations on an ongoing basis. Being able to understand and make use of reported financial data helps improve the investor's knowledge of a corporation and, thus, the chance of making wise decisions about the buying and selling of capital shares. Ignorance often leads to poor decisions and much less lucrative outcomes.

13. An electronic market that allows for the trading of capital shares in approximately three thousand companies, providing instantaneous price quotations to efficiently match buyers and sellers allowing ownership in companies to change hands.

In the United States, such investment gains—if successfully generated—are especially appealing to individuals when ownership shares are held for over twelve months before being sold. For income tax purposes, the difference between the buy and sale prices for such investments is referred to as a long-term capital gain or loss. Under certain circumstances, significant tax reductions are attributed to long-term capital gains. This same tax benefit is not available to corporate taxpayers, only individuals. The U.S. Congress created this tax incentive to encourage additional investment so that businesses could more easily obtain money for growth purposes. When businesses prosper and expand, the entire economy tends to do better.

TEST YOURSELF

Question:

Mr. and Mrs. Randolph Ostar buy one thousand shares of a well-known company at \$25 per share on July 1, Year One. They hold no other investments. The stock is traded on the New York Stock Exchange, and the price goes up over time to \$36 per share. On June 27, Year Two, the couple is considering the sale of these shares so that they can buy a new car. At the last moment, they postpone these transactions for one week. What is the most likely reason for this delay?

- a. Automobile prices tend to go down after July 1 each year.
- b. It normally takes several weeks to sell the shares of a large corporation.
- c. Laws delay the immediate use of money from the sale of investments for several weeks.
- d. They are hoping to reduce the amount of income taxes to be paid.

Answer:

The correct answer is choice d: They are hoping to reduce the amount of income taxes to be paid.

Explanation:

For individuals who own stock, gains on the sale of capital assets (such as these shares) are taxed at low rates, but only if long-term (held for over one year). The Ostars anticipate making an \$11,000 profit ($\$36 - \$25 \times 1,000$ shares). Currently, the shares have been held for slightly less than one year. If sold in June, the gain is short-term and taxed at a higher rate. By holding them for just one more week, the gain becomes long-term, and a significant amount of tax money is saved.

The Receipt of Dividends

Question: Investors acquire ownership shares of selected corporations hoping that the stock price will rise over time. This investment strategy is especially tempting because long-term capital gains are often taxed at a relatively low rate. Is the possibility for appreciation in value the only reason that investors choose to acquire capital shares?

Answer: Many corporations—although certainly not all—pay cash **dividends**¹⁴ to their stockholders periodically. A dividend is a reward for being an owner of a business that is prospering. It is not a required payment; it is a sharing of profits with the stockholders. As an example, for 2010, **Duke Energy** reported earning profits (net income) of \$1.32 billion. During that same period, the corporation distributed total cash dividends of approximately \$1.28 billion to the owners of its capital stock. The receipt of cash dividends is additionally appealing to stockholders because, in most cases, they are taxed at the same reduced rates as are applied to net long-term capital gains.

The board of directors determines whether to pay dividends. Some boards prefer to leave money within the business to stimulate future growth and additional profits. For example, **Google Inc.** reported profits (net income) for 2010 of \$8.51 billion but distributed no dividends to its owners. Newer companies often choose to pay less dividends than older companies as they try to grow quickly to a desired size.

Not surprisingly, a variety of investing strategies abound. Many investors acquire ownership shares almost exclusively in hopes of benefiting from an anticipated appreciation of stock prices. Another large segment of the investing public is more likely to be drawn to the possibility of dividend payments. Unless an owner has the chance to influence or control the operations of a business, only these two potential benefits can accrue from the ownership of capital shares: appreciation in the value of the stock price and cash dividends.

Annual Rate of Return on an Investment in Capital Stock

Question: An investor can put money into a savings account at a bank and earn a small but relatively risk-free profit. For example, \$100 could be invested on January 1 and then be worth \$102 at the end of the year because interest is added to the balance. The extra \$2 means that the investor earned an annual return of 2 percent (\$2 increase/\$100 investment). This computation helps in comparing one possible investment opportunity against another. How is the annual rate of return computed when the capital stock of a corporation is acquired as an investment and then held for a period of time?

14. Distributions made by a corporation to its shareholders as a reward when income has been earned; decision to pay is made by the board of directors; shareholders often receive favorable tax treatment when cash dividends are collected.

Answer: Capital stock investments are certainly not risk free. Profits can be high, but losses always loom as a possibility. The annual rate of return measures those profits and losses in the past and is often anticipated for the future as a way of making investment decisions.

To illustrate, assume that on January 1, Year One, an investor spends \$100 for one ownership share of the Ace Company and another \$100 for a share of the Base Company. During the year, Ace distributes a dividend of \$1.00 per share to each of its owners while Base pays a dividend of \$5.00 per share. On December 31, the capital stock of the Ace Company is selling on a stock market for \$108 per share whereas the stock of the Base Company has a price of only \$91 per share.

This investor now holds a total value of \$109 as a result of the purchase of the share of the Ace Company: the cash dividend of \$1 and a share of capital stock worth \$108. In one year, the total value has risen by \$9 (\$109 less \$100) so that the annual rate return was 9 percent (\$9 increase/\$100 investment).

The shares of the Base Company did not perform as well. At the end of the year, the total value of this investment is only \$96: the cash dividend of \$5 plus one share of stock worth \$91. That is a drop of \$4 during the year (\$96 less \$100). The annual rate of return on this investment is a negative 4 percent (\$4 decrease/\$100 investment).

As a result of this first year, buying a share of Ace obviously proved to be a better investment than buying a share of Base because of the higher annual rate of return. However, a careful analysis of the financial accounting data available at the start of the year might have helped this investor realize in advance that the rate of return on the investment in Ace would be higher. An assessment of the financial health and future prospects of both businesses could have shown that a higher return was expected in connection with the investment in Ace.

Therefore, estimating the annual rate of return is important for investors because it helps them select from among multiple investment opportunities. This computation provides a method for quantifying the financial benefit earned in the past and expected in the future. Logically, investors should simply choose the investment that provides the highest anticipated rate of return. However, as with all predictions, the risk that actual actions will not follow the expected course must be taken into consideration. Investing often breaks down to anticipating profits while measuring the likelihood and amount of potential losses.

KEY TAKEAWAY

Incorporation allows an organization to be viewed legally as a separate entity apart from its ownership. In most large corporations, few owners are able to be involved in the operational decision making. Instead, stockholders elect a board of directors to oversee the business and direct the work of management. Corporations can issue shares of capital stock that give the holder an ownership right and enables the business to raise monetary funds. If the organization is financially healthy and prospering, these shares can increase in value over time—possibly by a significant amount. In addition, a profitable organization may well share its good fortune with its ownership through the distribution of cash dividends. Investors often attempt to estimate the annual rate of return that can be expected from an investment as a way of comparing it to other investment alternatives. This computation takes the profit for the year (stock appreciation and dividends) and divides it by the amount of the investment at the start of the period.

1.3 Using Financial Accounting for Wise Decision Making

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. List the predictions that investors and potential investors want to make about a business organization.
2. List the predictions that creditors and potential creditors want to make about a business organization.
3. Explain the reporting of monetary amounts as a central focus of financial accounting.
4. Explain how financial accounting information is enhanced and clarified by verbal explanations.
5. Understand the function played by the annual report published by many businesses and other organizations.

Financial Accounting Information and Investments in Capital Stock

Question: Investors are interested (sometimes almost obsessively interested) in the financial information that is produced by a business organization according to the rules and principles of financial accounting. They want to use this information to make wise investing decisions. What do investors actually hope to learn about a business by analyzing published financial information?

Answer: The information reported by financial accounting is similar to a giant, complex portrait painted of the organization. There are probably hundreds, if not thousands, of aspects of the picture that can be examined, analyzed, and evaluated to help assess the financial health and future prospects of the model. Theories abound as to which pieces of information are best to use when studying a business. One investor might prefer to focus on a particular portion of the data almost exclusively (such as profitability) whereas another may believe that entirely different information is most significant (such as the sources and uses of cash).

Ultimately, in connection with the buying and selling of capital stock, all investors are trying to arrive at the same two insights. They are attempting to use the provided financial accounting data to estimate the following:

1. The price of the corporation's capital stock in the future
2. The amount of cash dividends that will be paid over time by the business

Despite the complexity of the information, these two goals are rather simplistic. If an investor owns capital shares of a business and feels that the current accounting information signals either a rise in stock prices or strong dividend distributions, holding the investment or even buying more shares is probably warranted. Conversely, if careful analysis indicates a possible drop in stock price or a reduction in dividend payments, sale of the stock is likely to be the appropriate action.

Interestingly, by the very nature of the market, any exchange of ownership shares means that the buyer has studied available information and believes the future to be relatively optimistic for the business in question. In contrast, the seller has looked at similar data and arrived at a different, more pessimistic outlook.

TEST YOURSELF

Question:

An investor is currently studying the financial information produced by Company A and also by Company B. The investor holds ownership shares of Company A but not Company B. After studying all the available data, the investor sells her shares of Company A and uses the proceeds to buy shares of Company B. What is the most likely explanation for these actions?

- a. Company B has been more profitable than Company A in the past.
- b. Company B has paid a larger dividend than Company A in the past.
- c. Last year, the price of Company B's stock rose faster than that of Company A.
- d. Company B is poised to be more profitable than Company A in the future.

Answer:

The correct answer is choice d: Company B is poised to be more profitable than Company A in the future.

Explanation:

Investors use data to anticipate changes in stock prices and dividend payments. Such events are affected by an organization's financial health and future prospects. Historical data, such as profitability, dividends, and stock prices, are helpful but only if they provide guidance as to what will happen in the future. If Company B is expected to be more profitable in the coming year, that outcome may well translate into a strong appreciation in the price of the stock or high dividend payments.

Financial Accounting Information and Other Interested Parties

Question: Are there reasons to analyze the financial accounting information produced by a particular business other than to help investors predict stock prices and cash dividend payments?

Answer: The desire to analyze an organization's financial situation is not limited to investors in the stock market. For example, as discussed previously, a loan might be requested from a bank, or one business could be considering the sale of its merchandise to another on credit. Such obligations require eventual payment. Therefore, another portion of the individuals and groups that study the financial information reported by an organization wants to assess the likelihood that money will be available in the future to pay debts. Stock prices and cash dividend distributions are much less significant to a creditor.

The same financial data utilized by investors who are buying or selling capital stock will also be of benefit to current and potential creditors. However, this group is likely to focus attention on particular elements of the information such as the sheer amount of the debt owed, when that debt is scheduled to come due, and the perceived ability to generate sufficient cash to meet those demands in a timely fashion. Ultimately, creditors attempt to anticipate the organization's future cash flows to measure the risk that debt principal and interest payments might not be forthcoming when due. Cash flows also influence stock prices and dividend payments and would, thus, be information useful for potential investors in the capital stock of a company as well as its creditors.

Therefore, millions of individuals and groups use reported financial information to assess business organizations in order to make three predictions:

- Future stock market prices for the capital shares issued by the business
- Future cash dividend distributions
- Future ability to generate sufficient cash to meet debts as they mature

The first two relate to investors in the capital stock issued by the corporation; the third is of more significance to the creditors of that organization.

The Nature of Financial Information

Question: The term "financial information" comes up frequently in these discussions. What is meant by financial information?

Answer: Financial information reported by and about an organization consists of data that can be measured in monetary terms. For example, if a building costs \$4 million to acquire, that is financial information, as is the statement that a debt of \$700,000 is owed to a bank. In both cases, relevant information is communicated to

decision makers as a monetary balance. However, if a business has eight thousand employees, that fact might be interesting, but it is not financial information. The figure is not a dollar amount; it is not stated in the form that is most useful for decision-making purposes by either investors or creditors. Assuming that those workers were paid a total of \$500 million during the most recent year, then that number is financial information because it reflects the amount of money spent.

Likewise, a men's clothing store does not include in its financial accounting information that it holds ten thousand shirts to be sold. Instead, the business reports that it currently owns shirts for sale (frequently referred to as **inventory**¹⁵) with a cost of, perhaps, \$300,000. Or, after having sold these items to customers, it could explain that total sales of \$500,000 were made during the period.

Financial Accounting and Verbal Explanations

Question: The value of reported data seems somewhat restricted if only amounts measured in dollars is included. Is financial accounting information limited solely to figures that can be stated in monetary terms?

Answer: Although financial accounting starts by reporting balances as monetary amounts, the communication process does not stop there. Extensive verbal explanations as well as additional numerical data are also provided to clarify or expand the monetary information where necessary. To illustrate, assume that an organization is the subject of a lawsuit and estimates an eventual loss of \$750,000. This is financial information that must be reported based on the rules of financial accounting. However, the organization should also communicate other nonfinancial information such as the cause of the lawsuit and the likelihood that the loss will actually occur. The dollar amount alone does not provide sufficient information for either investors or creditors.

Thus, accounting actually communicates to decision makers in two distinct steps:

1. Financial information is provided in monetary terms
2. Further explanation is given to clarify and expand on those monetary balances

15. A current asset bought or manufactured for the purpose of selling in order to generate revenue.

The Annual Report

*Question: Businesses and other organizations must have some structural method for conveying financial information and additional verbal explanations to outside decision makers. If a potential investor or creditor wants to assess a business organization such as **Johnson & Johnson** or **Colgate-Palmolive**, in what form is that information delivered?*

Answer: Most companies regardless of size prepare and distribute an annual report shortly after the end of each year. For example, the 2010 annual report of the **McDonald's Corporation** can be downloaded from the Internet at http://www.aboutmcdonalds.com/mcd/investors/annual_reports.html. The annual report for the **McDonald's Corporation** can also be found by following these steps:

1. Go to <http://www.mcdonalds.com>.
2. Scroll to the bottom of the page and click on "Corporate."
3. At the top of the next screen, click on "Investors" at the top of the page.
4. A picture of **McDonald's** latest annual report should be on the next screen. Click on that picture for it to download.

This publication is over fifty pages in length and contains virtually any financial accounting information that a potential investor or creditor could need to make an estimation of the future stock price for the capital stock issued by **McDonald's** as well as future dividend distributions and cash inflows and outflows. For example, here are some of the most relevant pieces of information included in the company's 2010 annual report.

- Pages 1 through 3 is a letter to shareholders from the chief executive office, the person who is the head of **McDonald's** management.
- Page 4 is a letter to shareholders from the chair of the board of directors.
- Pages 9 through 25 present management's discussion and analysis of the company's financial condition and results of operations.
- Pages 26 through 29 contain the financial accounting information formally reported by **McDonald's**.
- Pages 30 through 42 provide verbal explanations and other additional information to help clarify the monetary balances reported on pages 26 through 29.

- Page 46 identifies the executive members of management and the officers who work for **McDonald's**.
- Page 47 lists the members of the board of directors.

This textbook will focus on helping students gain an understanding of the financial accounting information that is produced by a business organization as exemplified by **McDonald's** on pages 26 through 29 and then explained further in pages 30 through 42. Those seventeen pages form the heart of the financial reporting process for this organization. Here in Chapter 1 "What Is Financial Accounting, and Why Is It Important?", most students will understand very little of the available data about **McDonald's**. However, with careful reading, thought, and work, by the conclusion of Chapter 17 "In a Set of Financial Statements, What Information Is Conveyed by the Statement of Cash Flows?", students should have a working knowledge of financial accounting and its rules and procedures. They will then be able to analyze a good percentage of the information reported by any business as a basis for making wise decisions about the buying and selling of its capital stock and the extension of credit and loans.

KEY TAKEAWAY

Throughout the world each day, investors buy and sell the capital stock shares of thousands of businesses. Other individuals choose to loan money or grant credit to these same organizations. Such decisions are based on assessing potential risks and rewards. Financial accounting provides information to these decision makers to help them evaluate the possibility of capital stock price appreciation, cash dividend distributions, and the business's ability to generate cash to meet obligations as they come due. This information is financial in nature, meaning that it is stated in monetary terms. However, numerical data alone is of limited value. Thus, financial accounting provides monetary balances as well as clarifying verbal explanations to assist users in assessing the financial health and future prospects of a particular business. This information is made available to interested parties as one portion of the annual report that most business corporations produce each year.

Talking with a Real Investing Pro

Kevin G. Burns is a partner in his own registered investment advisory firm, the **LLBH Private Wealth Management Group**, an organization that specializes in asset management, concentrated stock strategies, and wealth transfer. **LLBH** consults on investing strategies for assets of nearly \$1 billion. Before starting his own firm in October 2008, he was first vice president of **Merrill Lynch Private Banking and Investment Group**. Burns began his career on Wall Street in 1981 at **Paine Webber**. He has also worked at **Oppenheimer & Co.** and **Smith Barney**. Burns has appeared several times on the CBS Evening News. He has been kind enough to agree to be interviewed about his opinions and experiences in using financial accounting information. His thoughts will appear at the end of each chapter. His firm's Web site is <http://www.LLBHprivatewealthmanagement.com>.

Question: You majored in accounting in college but you never worked in the accounting field. Instead, you became an investment advisor. If you never planned to become an accountant, why did you major in that subject?

Kevin Burns: In my view, accounting is the backbone of any business major in college. Being able to translate the information that a company provides, prepare a budget, understand the concept of revenues and expenses, and the like has been enormously helpful in my investment management business. Anyone majoring in any aspect of business needs that knowledge. I also liked being able to know I had the right answers on the tests that my accounting professors gave me when all the numbers added up properly.

Question: Why do you prefer to invest in the capital stock of a business rather than put your client's money in other forms of investment such as gold or real estate?

KB: I think it is very important to diversify investments. In my world, that includes stocks as well as other types of investments. Of course, there is a place for investments in real estate, commodities, and the like. My personal

preference is to invest only in very liquid assets; those—such as capital shares—that can be turned into cash quickly through trades on a stock exchange. I like to know, even if I am investing for the long term, that I can sell my investments five minutes after I buy them should I change my mind. I simply prefer liquid investments. Real estate is not very liquid as the housing market has recently shown. Gold, of course, is liquid. However, while it has appreciated lately, it was selling for around \$800 an ounce when I was in high school and is now about \$1,800 an ounce. Over a thirty-year period of time, that is not a very big profit. If my clients earned that small of a return on their money over thirty years, they would fire me.

What Was Truly Important?

To students of Financial Accounting:

You have now read [Chapter 1 "What Is Financial Accounting, and Why Is It Important?"](#). What were the five points that you discovered in this chapter that seemed most important to you? A lot of information is provided here. What stood out as truly significant? After you make your choices, go to the following link and watch a short video clip where Professor Joe Hoyle will choose his top five points from [Chapter 1 "What Is Financial Accounting, and Why Is It Important?"](#). You can learn his rationale for these picks and see whether you agree or disagree with those selections.

Video Clip

[\(click to see video\)](#)

Professor Joe Hoyle talks about the five most important points in [Chapter 1 "What Is Financial Accounting, and Why Is It Important?"](#).

1.4 End-of-Chapter Exercises

QUESTIONS

1. James Watkins is signing up for classes at his college for the upcoming semester and is thinking of taking a course in financial accounting. What is financial accounting?
2. What decisions are often associated with financial accounting?
3. How does financial accounting differ from managerial accounting?
4. Who are some of the most likely users of the information provided by financial accounting?
5. Betsy Ligando and Cynthia Zvyvco are planning to start a business where they will sell greeting cards in a leased space at the local shopping center. A friend told them that they should create their business as a corporation. What is a corporation?
6. From question 5, assume that the owners choose not to incorporate their business. What type of business will they create and what risks are involved?
7. From question 5, assume that the owners decide that their business will be created as a corporation. How does a business become a corporation?
8. What are the advantages of operating a business as a corporation?
9. What purpose does a board of directors serve in a corporation?
10. Tyrone Waters works part time during the school year and has saved up cash amounting to \$2,000. He wants to invest that money in the capital stock of a business such as **Walmart**. Why would Waters use his money to buy ownership shares of this business?
11. An investor in the capital stock of a business will often look at available financial accounting information in a different way than a creditor or lender. How do the needs of these two groups differ?
12. What is financial information?
13. What is a dividend? Who makes the decision for a business corporation to distribute a dividend? Why is a dividend distributed?
14. Daisy Miller owns one hundred shares of the capital stock of Aground International, a business organization with its headquarters in her hometown. The company mails her a copy of its latest annual report. What is the purpose of the annual report?
15. Jimi Tattaro puts \$500 into a savings account and closes it out one year later by removing all \$515 that is now in the account. He also spent \$600 to invest in the capital shares of the YxWho Corporation. He sold those shares one year later for \$638. Before the sale, he received a \$4 cash dividend from YxWho. What is the annual return on each of these investments?

TRUE OR FALSE

1. ____ Financial accounting information is generated primarily to help with decisions made inside a business or by some other organization.
2. ____ Typically, a business operated as a sole proprietorship will be able to raise money from issuing capital shares easier than will a business operated as a corporation.
3. ____ Employees have no reason to be interested in any financial accounting information provided by their employer.
4. ____ Most investors in the capital stock of a business want to be involved in the daily operations.
5. ____ The board of directors of a corporation is elected by its shareholders.
6. ____ Investors who hold investments in capital stock for longer than a year may enjoy a tax benefit.
7. ____ In analyzing a business, creditors are most interested in the possibility that the corporation's stock price might decline.
8. ____ Corporations that report earning additional profits are required by law to pay dividends to their shareholders.
9. ____ Purchasing the capital stock of a business is typically a riskier investment than opening a savings account.
10. ____ Financial information is communicated in monetary terms but may be explained verbally.
11. ____ Most businesses report their financial accounting information as part of an annual report released to owners and other interested parties.
12. ____ Accountants are the primary users of the information provided by financial accounting.
13. ____ An entity that loans money to a business is referred to as a "shareholder."

MULTIPLE CHOICE

1. Ramon Sanchez is a loan officer at Washington Bank. He is in the process of deciding whether or not to loan money to Medlock Corporation. Which of the following would have the most influence on Sanchez when making this decision?
 - a. Medlock generated positive cash flows last year.
 - b. Medlock paid dividends last year.
 - c. Medlock's stock price increased last year.
 - d. The number of stockholders in Medlock increased last year.

2. Which of the following is not a reason for an investor to purchase capital stock in a relatively large corporation?
 - a. To receive dividend payments
 - b. To sell the stock for a gain if the share price increases
 - c. To earn a return on their investment
 - d. To participate in the day-to-day operations of the business

3. Which of the following is not a decision that is normally made using financial accounting information?
 - a. An investor decided to acquire shares of the capital stock of Rayburn Corporation.
 - b. A credit analyst at Mayfield Corporation rejected a request for credit from Rayburn Corporation.
 - c. A Rayburn Corporation manager decided to increase the quantity of widgets produced each month for sales purposes.
 - d. A loan officer at Fairburn Bank chose to grant a loan request made by Rayburn Corporation so the company could expand.

4. Which of the following individuals is most likely to have a say in the policy decisions made by a large corporation?
 - a. A stockholder
 - b. A member of the board of directors
 - c. An employee
 - d. A creditor

5. Leon Williams is an investor in Springfield Corporation. On January 1, Year One, he purchased 150 shares of the corporation's capital stock at a price of \$45 per share. On October 15, Year One, Springfield distributed a cash dividend of \$1.50 per share to its stockholders. On December 31, Year One, Springfield's stock is selling for \$47 per share. What is the annual rate of return on William's investment during Year One, rounded to one decimal point?
 - a. 3.3 percent
 - b. 4.4 percent
 - c. 5.5 percent
 - d. 7.8 percent

6. At the beginning of the current year, the capital stock of the Ajax Corporation was selling for \$24 per share, but, by the end of the year it was selling for \$35 per share. Which of the following individuals is the least likely to pay significant attention to this jump in stock price?
 - a. The vice president in charge of advertising working on the budget for this coming year
 - b. The loan officer at the bank who granted Ajax a loan late last year
 - c. Chair of the board of directors
 - d. Head of a local investment advisory company

7. Which of the following is least likely to be found in the financial information provided in the annual report of a large corporation?
 - a. The amount of cash dividends paid in each of the last three years.
 - b. The total amount of debt owed by the corporation.
 - c. The rationale for deciding to rent a new airplane rather than buying it.
 - d. The amount of cash held by the business at the end of the year.

8. William Alexander invests money to become one of the owners of a local restaurant. He sells his interest three months later

because he wants to invest in a bookstore. Which is the most likely legal structure for the restaurant?

- a. Sole proprietorship
- b. Partnership
- c. Standard operating business
- d. Corporation

VIDEO PROBLEMS

Professor Joe Hoyle discusses the answers to these two problems at the links that are indicated. After formulating your answers, watch each video to see how Professor Hoyle answers these questions.

1. Your roommate is an English major. The roommate has just learned that you are taking a course in financial accounting. The roommate has never once considered taking a class in business and is mystified that you have chosen to spend your time learning this material. One evening, over pizza, you two are discussing your classes for the semester. The roommate wants to know why anyone could possibly benefit from a class in financial accounting. How would you respond?

[\(click to see video\)](#)

2. Your uncle has worked for a large office supply business for twenty years. They have approximately one hundred retail stores located across the country. He is responsible for a small team of employees who do the interior design work in each of these stores. One day he sends you the following e-mail: “As a reward for twenty years of service, my company has offered to sell me one thousand shares of their capital stock for \$23 per share. That’s \$23,000, and that is a lot of money. I’ve never been interested in this aspect of business. I understand you are taking a financial accounting course in college. What are capital shares? More importantly, how can I determine whether to spend \$23,000 for these shares?”

[\(click to see video\)](#)

PROBLEMS

1. Explain how each of the following individuals might use the information provided by financial accounting about the Nguyen Company, which is located in Falls Church, Virginia.
 - a. Bank loan officer considering loaning money to Nguyen Company
 - b. Current employee of Nguyen Company
 - c. Potential employee of Nguyen Company
 - d. Current investor in Nguyen Company
 - e. Potential investor in Nguyen Company
 - f. A credit analyst of company wanting to sell inventory to Nguyen Company
2. Mark each of the following with an (F) to indicate if it is financial information or an (N) to indicate if it is nonfinancial information.

Metro Corporation has the following:

- a. ____ Cash of \$4,000,000
 - b. ____ A building that cost \$50,000,000
 - c. ____ 2,000 employees
 - d. ____ Inventory with a cost of \$16,000,000
 - e. ____ 500 shares of capital stock
 - f. ____ 1,000 trucks
 - g. ____ Sales of merchandise for \$45,000,000
 - h. ____ 2,000 cans of beans for resale purposes
 - i. ____ 2,000 cans of beans to be used in the employee cafeteria
3. Assume that a person you know tells the following story: “I inherited \$3,000 from a distant uncle. I took that money and invested it all in the capital shares of **Ford Motor Co.** I had looked at several other corporations including **Intel**, **PepsiCo**, **Microsoft**, and **Google**. Eventually, though, I put my money into **Ford.**”

Answer the following questions:

- a. What is meant by “the capital shares of **Ford Motor Co.**?”

- b. Why would a person spend \$3,000 to buy the capital shares of any business?
- c. Provide some possible reasons for this person to have invested in **Ford** rather than in those other corporations.
- d. In what way might the annual report of **Ford Motor Co.** have helped the person to make this decision?

RESEARCH ASSIGNMENTS

1. The chapter introduced several forms of business, including a corporation, sole proprietorship, and partnership. Other forms of business exist as well. Do an Internet search to learn as much as you can about each of the following business forms:
 - Sole proprietorship
 - Partnership
 - Limited partnership
 - C corporation
 - S corporation
 - Limited liability corporation (LLC)

For each of these legal forms, discuss the following issues: ease of organization and maintenance of form, number of people involved, government involvement, liability to owners, ease of exit, taxation, day-to-day management, and funding sources.

2. A great amount of financial information is available on the Internet about most business corporations of any significant size. For example, visit <http://www.google.com/finance/>. In the “Get Quotes” box, type in “**Starbucks Corporation.**”

Answer each of the following questions based on the information provided at this site:

- a. For what price is the capital stock issued by **Starbucks** currently selling?
- b. On what stock market or exchange are the shares of **Starbucks** bought and sold?
- c. For convenience, the names of corporations that are listed on stock markets have a ticker symbol. This symbol is a shorthand method of identifying the business. What is the ticker symbol for **Starbucks**?
- d. Investors are often interested in the movement of the price of a share of stock during recent months. What is the fifty-two week range in the price of **Starbucks**' stock? Is the current price closer to the high or to the low in that range?
- e. Investors are also interested in comparing a business operation to other businesses in the same or related

- industry. Investors want to know how the company does in comparison to its chief competitors. List three corporations that may be competitors of **Starbucks**.
- f. Read the description of this business and list three things that you found most interesting.
 - g. Provide the names of three officers and three members of the board of directors.
3. The U.S. Department of Labor has a page on its Web site at <http://www.bls.gov/oco/ocos001.htm> that is titled “Accountants and Auditors.” Go to this site and read this page. Use that information to answer the following questions:
- a. In general, what functions do accountants perform?
 - b. Briefly list the different types of accountants and what they do.
 - c. What education is required to become an accountant or an auditor?
 - d. What is a CPA?
 - e. What are the typical requirements to become a CPA?
 - f. What other certifications are available for accountants?
 - g. What is the current job outlook for the accounting profession?
4. Go to <http://www.target.com/>. At the **Target Corporation** Web site, scroll to the bottom of that page, find “Company Information,” and click on “Investors.” Then, click on “Annual Reports.” Click on the 2010 annual report and answer the following question:

Starting on page 2, a two-page letter is included “to our shareholders” from the chairman, president, and CEO. Read that letter. Assume you are thinking about buying shares of the capital stock of **Target**. List two or three pieces of information that you found in this letter that you felt were especially relevant to your decision.