

Introduction to Accounting and Business

OPENING COMMENTS

For many students, Chapter 1 of *Accounting* is their first taste of the business or accounting disciplines. The teaching challenge is to get students to understand and accept the importance of learning business and accounting concepts. This will make the course more than just another requirement that students must complete to graduate. Because this chapter will set the tone for the entire course and their business careers, avoid the temptation to rush through the material.

Chapter 1 begins with a discussion of the nature of a business and the different types of businesses (service, merchandising, and manufacturing) and types of business organizations (proprietorship, partnership, corporation, and limited liability corporations). Next, the chapter describes internal and external users, and how their needs affect accounting systems. The chapter then moves onto business ethics, and discusses how individual character, firm culture, and laws and enforcement affect ethics as well as the accounting/business frauds of the 2000s. The roles of accounting in business and accounting professions/careers are discussed. Following this introductory information, the text explains generally accepted accounting principles (GAAP), the business entity concept, and the cost concept. The accounting equation is introduced, and then the discussion of how business transactions affect accounts in the accounting equation begins. When transactions are analyzed, changes in assets, liabilities, and owner's equity are stated as "increases" or "decreases"—the terms "account" (such as Cash, Supplies, etc.), "debit," and "credit" are not introduced until Chapter 2. The rules of using at least two accounts, selecting those account names, and maintaining the equality of the equation are discussed using several transactions for a business called NetSolutions. Next are examples of how to prepare all four financial statements using the accounting equation information and with explanations of how the four financial statements are interrelated. The chapter ends with an explanation of the ratio of liabilities to owner's equity and how it is particularly important to creditors.

After studying the chapter, your students should be able to:

1. Describe the nature of business and the role of accounting and ethics in business.
2. Summarize the development of accounting principles and relate them to practice.
3. State the accounting equation and define each element of the equation.
4. Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.
5. Describe the financial statements of a proprietorship and explain how they interrelate.
6. Describe and illustrate the use of the ratio of liabilities to owner's equity in evaluating a company's financial condition.

KEY TERMS

account form
account payable
account receivable
accounting
accounting equation
assets
balance sheet
business
business entity concept
business transaction
Certified Public Accountant (CPA)
corporation
cost concept
earnings
ethics
expenses
fees earned
financial accounting
Financial Accounting Standards Board (FASB)
financial statements
generally accepted accounting principles (GAAP)
general-purpose financial statements
income statement
interest revenue
International Accounting Standards Board (IASB)
liabilities
limited liability company (LLC)
management (or managerial) accounting
manufacturing business
matching concept
merchandising business
net income (or net profit)
net loss

objectivity concept
owner's equity
partnership
prepaid expenses
private accounting
profit
proprietorship
public accounting
Public Company Accounting Oversight Board (PCAOB)
ratio of liabilities to owner's (stockholders') equity
rent revenue
report form
revenue
sales
Sarbanes-Oxley Act (SOX)
Securities and Exchange Commission (SEC)
service business
statement of cash flows
statement of owner's equity
stockholders' equity
unit of measure concept

STUDENT FAQs

- Why do I have to take this course since my major is not “Accounting”?
- Why is “Accounting” so important?
- Why can't I just use a computer program to do all my accounting?
- Why is the accounting equation set the way it is? Why could it not be “Owner's Equity – Assets = Liabilities” or “Liabilities – Assets = Owner's Equity”?
- Why are net income and cash not the same?
- Why do people call revenue by so many names?
- Why do the financial statements have to go in a certain order?
- Why is Cash the first asset listed?
- What is the difference between revenues and assets?
- What is the difference between expenses and liabilities?
- Why does the balance sheet report the accounts at a point in time while the income statement and statement of owner's equity report the activity for a period of time? Shouldn't they all report for a period of time?
- Why use a ratio to judge a company's ability to pay its obligations rather than dollar amounts?
- What are the liability differences between sole proprietorships, partnerships, corporations, and LLCs?

OBJECTIVE 1

Describe the nature of business and the role of accounting and ethics in business.

SYNOPSIS

The first objective starts with a list of the three types of businesses: service, merchandising, and manufacturing. It defines each type of business and gives examples. The role of accounting in business is discussed along with the two types of users: internal and external. Exhibit 1 shows the various users and the data they require. Accounting information must be not only relevant and timely but also trustworthy. The failure of individual character and a culture of corporate greed led to the businesses in Exhibit 2 being convicted of accounting and business fraud. Opportunities for accounting are increasing as regulations increase, and people are beginning to realize the importance and value of accounting information. Exhibit 3 provides a list of accounting career paths and salaries.

Key Terms and Definitions

- **Accounting** - An information system that provides reports to stakeholders about the economic activities and condition of a business.
- **Business** - An organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers.
- **Certified Public Accountant (CPA)** - Public accountants who have met a state's education, experience, and examination requirements.
- **Ethics** - Moral principles that guide the conduct of individuals.
- **Financial Accounting** - The branch of accounting that is concerned with recording transactions using generally accepted accounting principles (GAAP) for a business or other economic unit and with a periodic preparation of various statements from such records.
- **General-Purpose Financial Statements** - A type of financial accounting report that is distributed to external users. The term "general purpose" refers to the wide range of decision-making needs that the reports are designed to serve.
- **Management (Managerial) Accounting** - The branch of accounting that uses both historical and estimated data in providing information that management uses in conducting daily operations, in planning future operations, and in developing overall business strategies.
- **Manufacturing Business** - A type of business that changes basic inputs into products that are sold to individual customers.
- **Merchandising Business** - A type of business that purchases products from other businesses and sells them to customers.
- **Private Accounting** - The field of accounting whereby accountants are employed by a business firm or a not-for-profit organization.
- **Profit** - The difference between the amounts received from customers for goods or services provided and the amounts paid for the inputs used to provide the goods or services.
- **Public Accounting** - The field of accounting where accountants and their staff provide services on a fee basis.
- **Public Company Accounting Oversight Board (PCAOB)** - A new oversight body for the accounting profession that was established by the Sarbanes-Oxley Act.
- **Sarbanes-Oxley Act (SOX)** - An act passed by Congress to restore public confidence and trust in the financial statements of companies.
- **Service Business** - A business providing services rather than products to customers.

Relevant Exhibits

- Exhibit 1 – Accounting as an Information System
- Exhibit 2 – Accounting and Business Frauds
- Exhibit 3 – Accounting Career Paths and Salaries

SUGGESTED APPROACH

The first class of your semester/quarter often sets the tone for the rest of the term. Many instructors believe it is easier to spark classroom discussion if you can get each student to speak on the first day of class and to write something about themselves. Objective 1 provides a good opportunity to encourage early class participation. Your students will be familiar with most of the terms introduced in this learning objective. Use the first writing exercise and classroom discussion suggestions to get students talking about business and accounting.

The text defines **accounting** as “an information system that provides reports to users about the economic activities and condition of a business.” Accounting is also known as the “language of business.” The goal of Objective 1 is also to make this definition meaningful and to make students aware of the uses of accounting data.

To spark discussion, you may want to ask students what they think of when they hear the term “**accounting**.” You could also ask what accounting information they or their families need in managing their finances (such as information for preparing income tax returns, budgeting everyday expenses, applying for personal loans, mortgage loans, or college loans, etc.).

This objective also introduces **ethical conduct** as it applies in the business setting. You may want to supplement text material by discussing the codes of professional ethics for accountants. The role of individual character, firm culture, and the laws and enforcement should be discussed as well as integrity and objectivity. This is a wonderful time to discuss these topics because we have such a long list of examples such as Enron, WorldCom, etc. Ask the students if they themselves, friends, or family members have lost money due to any of these companies. Some will have never heard of these companies, while others will have very good stories to tell in the classroom. Refer to Exhibit 2 for examples of accounting and business frauds.

It may be important to point out the reason these ethical codes are necessary. Accountants are privy to a variety of private and often sensitive information about businesses. Without these ethical codes, the accountant can be in a position to impact the businesses future in a significant way, either positively or negatively. This trusted relationship between business and accountant requires that the accountant live by these codes of conduct.

The Institute of Management Accountants and the American Institute of Certified Public Accountants codes of ethics are excellent items to review and are shown below. It is important to illustrate how these codes can be used to help accountants make difficult decisions. Four cases, which should stimulate a class discussion on ethics, are described in the Class Discussion section below.

Institute of Management Accountants Standards of Ethical Conduct:

1. Maintain an appropriate level of professional competence.
2. Refrain from disclosing confidential information.
3. Avoid conflicts of interest.
4. Communicate information fairly and objectively.

American Institute of Certified Public Accountants Codes of Professional Conduct:

1. Exercise sensitive professional and moral judgment.
2. Act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
3. Perform all professional responsibilities with the highest sense of integrity.
4. Maintain objectivity and be free of conflicts of interest.
5. Observe the profession's technical and ethical standards and continually improve competency and quality of services.
6. Use ethical standards when determining the scope and nature of services to be provided.

You may want to refer to your college or university "Student Code of Conduct" as an example of ethical codes for students. You may want to hand out to each student your school's "Student Code of Conduct" and discuss it or have whoever is in charge of your "Student Code of Conduct" policy, such as Dean of Students, discuss issues relating to classroom learning, testing, and cheating. To spark discussion, ask your students to develop a "Student Code of Conduct" for your course. Controversial issues you could ask them to consider are whether or not their code of conduct should include a policy on attending classes, tardiness, cell phone ring/usage, what is considered cheating (electronically as well as manually), or the proper use of the solutions to test questions, exercises, and problems transferred electronically. Most colleges are constantly working on updating student code rules relating to technology.

This learning objective also provides the opportunity to stress that accountants do more than just prepare tax forms!

You may want to describe the differences between public and private accounting and then discuss the specialized fields in accounting.

If you want to emphasize the many employment alternatives available in accounting, ask students to bring in examples of advertisements for accounting positions from a local newspaper. If you know of an accounting professional with an especially interesting or unusual job, you may want to invite that individual to speak to your class. Even if this speaker must be scheduled later in the term, it will help emphasize the diversity in the accounting profession and dispel the "bean-counter" image.

You may also want to research the requirements for becoming a CPA in your state and share those with your students, or better yet have the accounting majors do it as a group project. Direct your students to your state CPA society (such as the OSCP for the State of Oklahoma at website <http://www.OSCPA.com> or TSCPA for the state of Texas at website <http://www.TSCPA.org>). You may even want to direct them to the student membership within your Society's Web page. Students gain a lot of information from this site.

WRITING EXERCISE—The Definition of Business

Everyone has heard the term “business.” Ask your students to write short sentences/phrases that describe a business they have recently used. After giving them a couple of minutes, ask your students to share their ideas as you make a list of their key phrases. Next, ask your students to use these ideas to write a definition of “business.” You may want to compare their definitions to the one provided in the text, which defines a business as “an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers.”

CLASS DISCUSSION—Types of Businesses

Have the class provide the names of businesses they have used in the past week. Include places they have shopped, eating establishments, products they use every day, and services they have used. When listing products, name the manufacturer; for iPod, for example, the manufacturer would be Apple. List these on the board or overhead.

Show a list of the three types of businesses:

- Service Businesses
- Merchandising Businesses
- Manufacturing Businesses

Have the students identify each listed business as service, merchandising, or manufacturing. Some will cross over categories. Nike, for example, manufactures and has merchandising outlets.

CLASS DISCUSSION—Ethics in Accounting

Read one or more of the following cases to the class and discuss whether or not the accountant acted ethically. You can stimulate discussion by playing “devil’s advocate”—arguing an opposing view to whatever opinion is first offered.

1. Lauren Smith is the controller for Sports Central, a chain of sporting goods stores. She has been asked to recommend a site for a new store. Lauren has an uncle who owns a shopping plaza in the area of town where the new store is to be located, so she decides to contact her uncle about leasing space in his plaza. Lauren also contacted several other shopping plazas and malls, but her uncle’s store turned out to be the most economical place to lease. Therefore, Lauren recommended locating the new store in her uncle’s shopping plaza. In making her recommendation to management, she did not disclose that her uncle owns the shopping plaza.

DISCUSSION NOTES: Lauren has a conflict of interest in recommending her uncle’s shopping plaza as a site for the new store. After reviewing the data, management at Sports Central may agree with Lauren that her uncle’s plaza is the most economical place to lease; however, Lauren should not make that recommendation without disclosing the family relationship. By hiding the conflict of interest, Lauren appears to lack integrity.

2. John Jones is the chief accountant for the Southwest district office of Security Life Insurance Company. While preparing the fourth-quarter sales report, John overheard the company president say that he would close Security's Phoenix office if it did not meet its fourth-quarter sales quota. John's best friend from college works at the Phoenix office.

Anxious to find out whether the office was in jeopardy, John immediately finished the Phoenix office's report, only to find that it showed sales 25 percent below the quota. Later that afternoon, the company president called John for Phoenix's sales results. John told the president that he had not finished preparing the sales report for the Phoenix office. John wanted time to compile data that might convince the president to continue operations in Phoenix, despite lagging sales.

DISCUSSION NOTES: Management accountants must communicate all information, both good and bad, fairly and objectively. It is not ethical to mislead management by withholding available information.

3. Tech-Smart Computer Company recently discovered a defect in the hard disks installed in its model R24 computer. The hard disk head in these units retracts too violently whenever the computers are turned off. As a result, the hard disks are destroyed after the computer is turned on and off approximately 500 times. Tech-Smart has sold 4,000 model R24 computers nationwide.

The marketing department at Tech-Smart contacted most of the 4,000 owners of the model R24 computer and discovered that 20 percent (or 800) use their computers in businesses that operate 24 hours per day. These customers never turn their computers off; therefore, the defect should not damage their hard disk units.

Judy Govan, Tech-Smart's controller, has been asked to determine the cost to correct the hard disk problem and recommend a course of action. After studying the marketing department's report, Judy decides to recommend that Tech-Smart replace the hard drives only in the 3,200 units used by customers who actually turn their computers off.

DISCUSSION NOTES: In the real world, accountants must be good stewards of company funds. For example, although it may be socially responsible to donate a portion of the company's profits to a well-deserved charity, it is financially irresponsible to donate funds needed to meet payroll or loan obligations. In this case, the 800 customers who do not turn off their computers will not experience any problem with the R24. Replacing the drives will be costly, but it will add no benefit. Therefore, it is ethical to replace only the drives at risk because of the defect. As with all business decisions, this savings must be weighed against potential future risk of disk failures causing problems for Tech-Smart's reputation and potential lost sales. The controller is a valued member of the entire senior management team, which will ultimately have to weigh the cost and the potential consequences of this decision.

4. Tom Brown, the controller for MicroTech Software Company, is responsible for preparing the company's financial statements. He learns that sales for the first quarter of the year have dropped so dramatically that the company is in danger of bankruptcy. As a result, he applies for an accounting position with another software company that competes with MicroTech. During his job interview, Tom is asked why he wants to leave MicroTech. He replies truthfully, "The company sales are down

another 10 percent this quarter. I fear they will go out of business.” At that time, MicroTech had not released its sales results to the public.

DISCUSSION NOTES: Tom may not disclose any confidential information. He is expressly forbidden from providing nonpublic sales information to anyone. Accountants are privy to a variety of private and often sensitive information about businesses. It is their ethical duty to maintain the confidentiality entrusted to them.

LECTURE AID—Accounting as an Information System

The goal of accounting can be illustrated using the following equation:

Goal of Accounting = Record + Report + Interpret Economic Data for use by decision makers

Ask your students to name those who would be interested in the economic results of a business. List their responses on the board. When complete, the list should contain many of the following:

1. Owner
2. Investors/Stockholders
3. Bankers
4. Governmental Agencies (e.g., IRS)
5. Managers
6. Employees
7. Customers
8. Competitors

After compiling this list, you may want to ask students to state what economic data each of those listed previously would be interested in seeing and why. Examples follow:

	<u>Interested In</u>	<u>Reason</u>
1. Owner	Sales	Is advertising effective?
	Profit	Can I take home more money each week?
	Cash	Can I afford to buy more equipment?
2. Investors/Stockholders. .	Profit	Is my investment making money?
	Dividends	What dividends are being paid?
3. Bankers	Debts	Can this business repay a loan?
4. IRS	Profit	What taxes does this business owe?
5. Managers	Expenses	Am I keeping expenses within my budget?
	Sales	Will I be eligible for a bonus this year?
6. Employees	Profit	Can my company afford raises?
		Is my job secure?
7. Customers	Amount spent	How dependable is this product?
	on warranty	How responsive is the service department?
	claims	
8. Competitors	Amount spent	How do I compare to my competitor?
	on ads	

You may want to emphasize that different accounting data are needed by different people and organizations. For example, a banker evaluating an application for a short-term loan and a public utility commission considering a rate increase would not consider the same types of accounting information.

GROUP LEARNING ACTIVITY—Accounting as an Information System

The ethics cases provided can be assigned to groups to discuss and present a brief explanation to the class as to their opinions and recommendations.

INTERNET ACTIVITY

Ask your students to research some nontraditional accounting careers. Two government organizations that hire accountants to help with investigations of fraud and criminal activities are the FBI and the IRS. Websites for these organizations are:

<https://www.fbijobs.gov>

<http://www.jobs.irs.gov>

Please note: Since website addresses frequently change, it is always a good idea to try these websites at the beginning of each term to check the accuracy of the Web addresses.

OBJECTIVE 2

Summarize the development of accounting principles and relate them to practice.

SYNOPSIS

Generally accepted accounting principles (GAAP) are used to prepare financial reports. This allows users to compare one company to another. In the United States, these principles are the responsibility of the Financial Accounting Standards Board (FASB). Companies that are publically traded are also guided by the Securities and Exchanges Commission (SEC). The FASB works with the International Accounting Standards Board (IASB) to reduce differences between international and U.S. standards. This help makes global investment and business easier. This chapter also introduces the four forms of business entities: sole proprietorship, partnership, corporation, and limited liability company. The cost concept requires that amounts are recorded at the actual price paid. The price paid is the primary objective measure as offers, appraisals, and opinions can be unstable over time. Financial data must also be recorded in a common unit of measure; GAAP requires dollars to be the common measure.

Key Terms and Definitions

- **Business Entity Concept** - A concept of accounting that limits the economic data in the accounting system to data related directly to the activities of the business.
- **Corporation** - A business organized under state or federal statutes as a separate legal entity.
- **Cost Concept** - A concept of accounting that determines the amount initially entered into the accounting records for purchases.

- **Financial Accounting Standards Board (FASB)** - The authoritative body that has the primary responsibility for developing accounting principles.
- **Generally Accepted Accounting Principles (GAAP)** - Generally accepted guidelines for the preparation of financial statements.
- **International Accounting Standards Board (IASB)** - An organization that issues International Financial Reporting Standards for many countries outside the United States.
- **Limited Liability Company (LLC)** - A business form consisting of one or more persons or entities filing an operating agreement with a state to conduct business with limited liability to the owners, yet treated as a partnership for tax purposes.
- **Objectivity Concept** - A concept of accounting that requires accounting records and the data reported in financial statements to be based on objective evidence.
- **Partnership** - An unincorporated business form consisting of two or more persons conducting business as co-owners for profit.
- **Proprietorship** - A business owned by one individual.
- **Securities and Exchange Commission (SEC)** - An agency of the U.S. government that has authority over the accounting and financial disclosures for companies whose shares of ownership (stock) are traded and sold to the public.
- **Unit of Measure Concept** - A concept of accounting requiring that economic data be recorded in dollars.

Relevant Example Exercise and Exhibit

- Exhibit 4 – Forms of Business Entities
- Example Exercise 1-1 – Cost Concept

SUGGESTED APPROACH

This objective introduces students to the Financial Accounting Standards Board (the FASB) and Generally Accepted Accounting Principles (GAAP). It is important to stress that the FASB is the organization that sets the standards that govern the rules of financial accounting. These rules are defined in GAAP. The International Accounting Standards Board (IASB) is the international equivalent of the FASB.

Optional discussion: *International Financial Reporting Standards (IFRSs)*. You may want to mention that work is currently under way to reach consensus on a set of worldwide accounting principles as the business world becomes increasingly global.

Additionally, this objective introduces the business entity concept, the cost concept, the objectivity concept, and the unit of measure concept—four principles that govern how accounting data are accumulated. Remind students that accounting data would be inconsistent from company to company if standardized procedures were not followed.

The following example may help in illustrating the business entity concept: If an individual owned a dry cleaner, a video store, and a gas station, how would the owner know the profitability of each? Answer: by keeping separate accounting records.

The cost concept can be explained through the purchase of a new truck for a business. As most students will recognize, the sticker price means nothing in the purchase of a new truck. Any student can identify several different prices available in the purchase process: the sticker price, the salesperson's offer price, prices obtained on the Internet by the buyer, and tax values; however, none of these matter. The only amount that matters is the actual price the business pays for the new truck. That original purchase price is recorded and remains on the books of the company until the truck is disposed of.

The writing exercise included below will help you determine whether your students can apply the business entity and cost concepts. This exercise can be assigned either (1) after you have briefly reviewed these two concepts in class or (2) before any in-class review as a test to see whether or not students have completed their reading assignment.

WRITING EXERCISE—Business Entity and Cost Concept

Ask students to write an answer to the following questions.

1. Sally Vertrees purchased a personal computer for use at home. Sally owns a dental practice. She occasionally uses the computer for a task related to her dental practice; however, the computer is used primarily by Sally's children. Can the computer be recorded as an asset in the accounting records of Sally's dental office? Why or why not?

Possible explanation: This is a violation of the business entity concept. Purchasing items for personal use from business funds will affect the reporting of how successful or unsuccessful a business purports to be for a financial period.

2. Jason Thompson purchased an office building 10 years ago for \$780,000. The building was just appraised at \$1.25 million. What value should be used for the building in Jason's accounting records? Support your answer.

Possible explanation: This is a clear example of the cost concept. Assets are recorded at cost and remain on the business books at cost until they are disposed of. Future economic conditions may change this appraised value; therefore, no adjustment is made until the asset is sold.

CLASS DISCUSSION—Types of Business Organizations

List the four types of business organizations. Next, ask students to name examples of each type of business.

Proprietorship
Partnership
Corporation
Limited Liability Corporation

Explain that in the early chapters of the text, they will be learning about accounting concepts related to service businesses organized as proprietorships. Take a page from the local phone book and ask students to identify each business by type.

You may also want to emphasize the following key facts about business organizations:

1. More than 70 percent of the businesses in the United States are organized as proprietorships.
2. About 10 percent of businesses are organized as partnerships and/or limited liability companies.
3. About 20 percent of businesses are organized as corporations; however, they generate over 90 percent of the total dollars of business receipts.

OBJECTIVE 3

State the accounting equation and define each element of the equation.

SYNOPSIS

This objective defines assets, liabilities, and owner's equity and uses the accounting equation ($\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$) to explain their relationship.

Key Terms and Definitions

- **Accounting Equation** - $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.
- **Assets** - The resources owned by a business.
- **Liabilities** - The rights of creditors that represent debts of the business.
- **Owner's Equity** - The owner's right to the assets of the business.
- **Stockholders' Equity** - The owners' equity in a corporation.

Relevant Example Exercise

- Example Exercise 1-2 – Accounting Equation

SUGGESTED APPROACH

This objective presents the accounting equation: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$. Following is an alternative way to describe this accounting equation, which is an effective lecture aid.

The Cost of the Items Used in Running a Business	=	Where the Funds to Buy Those Items Came from, Either Creditors or the Owner
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This objective also defines each element of the equation. Most students easily grasp the meaning of the terms “assets” (resources owned by a business) and “liabilities” (debts). “Owner’s equity,” however, is not a simple concept.

One way to explain owner’s equity is to compare it to the “equity” that a homeowner has in his or her home. Most students understand this usage of the term “equity.” A homeowner’s equity is that portion of his or her home’s value that would be received if the home were sold—it’s what would be left after

paying off the mortgage. In the same way, the owner's equity in a business is that owner's residual interest—what would be left if the assets were used to pay off all the business's debts. Use the following accounting equations to demonstrate the relationship between liabilities and owner's equity.

	Assets	=	Liabilities	+	Owner's Equity
Company A	100,000	=	95,000	+	5,000
Company B	100,000	=	90,000	+	10,000

To emphasize these new terms, ask your students to list their assets and liabilities on a sheet of paper and place a value on each item. Next, ask them to calculate their equity, which for individuals is often called “net worth.”

OBJECTIVE 4

Describe and illustrate how business transactions can be recorded in terms of the resulting change in the elements of the accounting equation.

SYNOPSIS

Using a sample company called NetSolutions, this objective demonstrates how business transactions affect a company's financial condition. Transactions, such as depositing cash, purchasing assets, selling services, and paying bills, etc., affect the accounting equation. This shows students that through each transaction the two sides of the accounting equation are always equal.

Key Terms and Definitions

- **Account Payable** - The liability created by a purchase on account.
- **Account Receivable** - A claim against the customer created by selling merchandise or services on credit.
- **Business Transaction** - An economic event or condition that directly changes an entity's financial condition or directly affects its results of operations.
- **Expenses** - Assets used up or services consumed in the process of generating revenues.
- **Fees Earned** - Revenue from providing services.
- **Interest Revenue** - Money received for interest.
- **Prepaid Expenses** - Items such as supplies that will be used in the business in the future.
- **Rent Revenue** - Money received for rent.
- **Revenue** - Increases in assets from performing services or delivering products to customers.
- **Sales** - The total amount charged customers for merchandise sold, including cash sales and sales on account.

Relevant Example Exercise and Exhibits

- Exhibit 5 – Summary of Transactions for NetSolutions
- Exhibit 6 – Types of Transactions Affecting Owner's Equity
- Example Exercise 1-3 – Transactions

SUGGESTED APPROACH

This objective illustrates recording business transactions within the framework of the accounting equation. The text defines a business transaction as “an economic event or condition that directly changes the entity’s financial condition or its results of operations.” Problem 1-1A or Problem 1-1B describe some of the economic events that are recorded as business transactions. This list can assist your students in determining which events/conditions to record. For practice, ask students to list transactions that they recently entered into with a business entity, such as purchasing gas for the car, getting their hair cut, or purchasing their textbook from the bookstore.

The basics of recording transactions can be effectively illustrated by working a sample problem for the students. Problem 1-1A or 1-1B provides several example transactions for a property rental management business or an insurance agency, respectively. You can use either of these problems to demonstrate how transactions are recorded. Any of the problems will work. Try to choose the problem opposite a homework assignment. If you usually work A problems as homework problems, then work all corresponding B problems in class. List the accounting equation elements that will be needed to record these transactions:

Accounts			Accounts			Owner’s	
Cash	Receivable	Supplies	Payable			Name,	
						Capital	+ Others (see problem)

You will probably need to emphasize the following points as you demonstrate transactions:

1. The accounting equation must always stay in balance. Transactions may require additions to both sides, subtractions from both sides, or an addition and a subtraction on the same side, but the equation must always balance.
2. Revenue represents the receipt of assets (cash or accounts receivable) for goods sold or services rendered. The receipt of assets from the owner is an investment by the owner, not revenue.
3. Revenues are recognized when services are rendered, not when the cash is received.
4. Expenses are costs incurred in generating revenues. Purchases of assets, payments of liabilities, and owner’s withdrawals are not recorded as expenses.

A discussion of the “six different categories of accounts” (Assets, Liabilities, Capital, Drawing, Revenue, and Expenses) may be beneficial at this time. Letting the students know that Capital and Revenue increase Owner’s Equity and Drawing and Expenses decrease Owner’s Equity can help students understand the impact that transactions have on the accounting equation.

It may be beneficial to write the accounting equation on the board and then rewrite the equation as follows: $\text{Assets} = \text{Liabilities} + \text{Owner's Capital} - \text{Owner's Withdrawals} + \text{Revenue} - \text{Expenses}$. Note that Owner’s Equity is affected by the last four variables in the equation. Two of them increase Owner’s Equity (Capital and Revenue), and two decrease Owner’s Equity (Drawing and Expenses).

GROUP LEARNING ACTIVITY—Recording Business Transactions

Rather than working through all of the transactions in Problem 1-1A or 1-1B for your students, consider working only the first few. Divide the class into small groups (two to three students) and ask them to complete the exercise in five to ten minutes. The solutions manual provides the solution. Give your students the opportunity to check their work and ask questions after they have completed their assignment.

OBJECTIVE 5

Describe the financial statements of a proprietorship and explain how they interrelate.

SYNOPSIS

This objective shows the income statement, statement of owner's equity, balance sheet, and statement of cash flows. Using the same NetSolutions example as the previous objective, the order, preparation, and relationship between the four financial statements is demonstrated. Each statement is prepared for a specific period of time, except the balance sheet; it is prepared for a point in time. Revenue minus expenses is known as net income; if expenses are greater than revenue, the excess is a net loss. The statement of owner's equity reports the changes in equity; the balance sheet reports the amount of assets, liabilities, and owner's equity and must follow the accounting equation. The statement of cash flows is prepared in Exhibit 8; it has three sections and each is described.

Key Terms and Definitions

- **Account Form** - The form of balance sheet that resembles the basic format of the accounting equation, with assets on the left side and Liabilities and Owner's Equity sections on the right side.
- **Balance Sheet** - A list of the assets, liabilities, and owner's equity as of a specific date, usually at the close of the last day of a month or a year.
- **Earnings** - The amount by which revenues exceed expenses.
- **Financial Statements** - Financial reports that summarize the effects of events on a business.
- **Income Statement** - A summary of the revenue and expenses for a specific period of time, such as a month or a year.
- **Matching Concept** - A concept of accounting in which expenses are matched with the revenue generated during a period by those expenses.
- **Net Income (or Net Profit)** - The amount by which revenues exceed expenses.
- **Net Loss** - The amount by which expenses exceed revenues.
- **Report Form** - The form of balance sheet with the Liabilities and Owner's Equity sections presented below the Assets section.
- **Statement of Cash Flows** - A summary of the cash receipts and cash payments for a specific period of time, such as a month or a year.
- **Statement of Owner's Equity** - A summary of the changes in owner's equity that have occurred during a specific period of time, such as a month or a year.

Relevant Example Exercises and Exhibits

- Exhibit 7 – Financial Statements
- Example Exercise 1-4 – Income Statement
- Example Exercise 1-5 – Statement of Owner’s Equity
- Exhibit 8 – Financial Statements for NetSolutions
- Exhibit 9 – Report Form of Balance Sheet
- Example Exercise 1-6 – Balance Sheet
- Example Exercise 1-7 – Statement of Cash Flows
- Exhibit 10 – Financial Statement Interrelationships

SUGGESTED APPROACH

This objective introduces the four financial statements of a proprietorship (in order of preparation: income statement, statement of owner’s equity, balance sheet, and statement of cash flows) and explains how they interrelate.

This objective also introduces the concept of “matching.” It is helpful to emphasize that matching is one of the most important concepts in accounting. If revenues and expenses are not properly matched, then the amount reported for net income is incorrect, making every statement thereafter incorrect.

CengageNOW has Excel spreadsheet templates (blank shells/forms) provided for preparing an income statement, balance sheet, and statement of owner’s equity for some of the exercises and problems. Review these formats with your class, emphasizing the following:

1. The date portion of the heading varies among the financial statements. The income statement, statement of owner’s equity, and statement of cash flows summarize transactions for a period of time, while the balance sheet shows a “snapshot” of the business on a particular date.
2. Net income from the income statement is used in calculating the ending capital balance on the statement of owner’s equity.
3. The ending capital balance from the statement of owner’s equity is the amount shown as “Capital” on the balance sheet. As a result, the balance sheet “balances.”

Next, ask your students to build on the transactions recorded for Problem 1-1A in the following Group Learning Activity.

After covering the income statement, statement of owner’s equity, and balance sheet, you may want to describe the statement of cash flows. The purpose of the statement of cash flows is to report cash received and cash paid in the course of doing business. Cash flows are divided into the following categories:

1. Cash flows from operating activities: Cash received or paid in
 - a. Providing services to a customer
 - b. Buying and selling a product
2. Cash flows from investing activities: Cash received or paid in
 - a. Buying or selling long-term assets

3. Cash flows from financing activities: Cash received or paid in
 - a. Investments and withdrawals by owner
 - b. Borrowing and repaying cash

Coverage of the cash flow statement also may be completely omitted at this point. Appendix D of the textbook contains examples of actual financial statements. You may want to refer students to these statements while covering this objective.

GROUP LEARNING ACTIVITY—Preparing Financial Statements

Use Problem 1-1A transactions solution (from the solutions manual) and divide the class into small groups. Ask students to use the balances from this problem to prepare financial statements for the month. The CengageNOW Excel spreadsheet templates can be used to provide a template for the students to follow. The income statement, statement of owner's equity, and balance sheet for Problem 1-1A follow.

Wilson Property Management
Income Statement
For the Month Ended June 30, 20Y1

Fees earned		\$26,800
Operating expenses:		
Rent expense	\$4,500	
Salaries expense	4,000	
Supplies expense	1,120	
Auto expense	750	
Miscellaneous expense	<u>980</u>	
Total operating expenses		<u>11,350</u>
Net income		<u>\$15,450</u>

Wilson Property Management
Statement of Owner's Equity
For the Month Ended June 30, 20Y1

Chad Wilson, capital, June 1		\$ 0
Investment by owner	\$30,000	
Net income for June	<u>15,450</u>	
Withdrawals	<u>(7,500)</u>	
Increase in owner's equity		<u>37,950</u>
Chad Wilson, capital, June 30		<u>\$37,950</u>

Wilson Property Management
Balance Sheet
June 30, 20Y1

Assets	
Cash	\$21,020
Accounts receivable	16,800
Supplies	<u>680</u>
Total assets	<u>\$38,500</u>
Liabilities	
Accounts payable	\$ 550
Owner's Equity	
Chad Wilson, capital, June 30	<u>37,950</u>
Total liabilities and owner's equity	<u>\$38,500</u>

Handout 1-1 (found at the end of this file) can be distributed here for the first time or re-assigned after a discussion about financial statements to see how students will perform with a little accounting knowledge on their side.

Handout 1-1 is a group exercise that has proven to be an excellent attention getter to assist students in creating financial statements and understanding the importance of consistent application of GAAP. The exercise gives students information about the operations of an upholstery shop for a period of one year. The students are asked to calculate the shop's profit.

The upholstery shop exercise contains many accounting twists that the beginning student will not know how to handle, such as credit customers who have not yet paid, supplies that have been purchased but not used, and assets that will last more than one year. These twists will generally spur considerable student discussion. They also allow the instructor to illustrate the need for standardized accounting procedures.

Begin this exercise by asking the class to define the word "profit." Next, divide the students into small groups (two to five students). Ask them to read the upholstery shop exercise and determine the shop's profit. It is best to put the students at ease by announcing that, for today, there will be no "incorrect" answers. Give the students 10 to 15 minutes to work. Ask for each group's answer, and record it on the board.

The groups typically will provide a wide range of answers. This will allow you to emphasize that there must be standards for recording business transactions and rules on how to determine profit if that information is going to be useful to decision makers.

Once students have spent time attempting to calculate the profits on their own, provide an income statement in proper form to demonstrate the correct solution.

For your information, the shop's net income for its first year of operation is \$18,580.

OBJECTIVE 6

Describe and illustrate the use of the ratio of liabilities to owner's equity in evaluating a company's financial condition.

SYNOPSIS

Using the financial statements prepared in the previous objective, the use of the ratio of liabilities to owner's equity is examined. The total liabilities is divided by the total owner's equity to calculate this ratio. Since creditors have rights to a business's assets before the owner, this ratio is important to both owners and creditors. This ratio can affect how a business pays its creditors and foretells how well a business will do in poor economic conditions. As this ratio increases, the creditors and the business become more at risk.

Key Term and Definition

- **Ratio of Liabilities to Owner's (Stockholders') Equity** - A comprehensive leverage ratio that measures the relationship of the claims of creditors to stockholders' equity.

Relevant Example Exercise

- Example Exercise 1-8 – Ratio of Liabilities to Owner's Equity

SUGGESTED APPROACH

This objective introduces the ratio of liabilities to owner's equity. Explain that the ability of a business to meet its financial obligations is a measure of the strength or weakness of its financial condition.

Remind students that the rights of creditors to a business's assets come before the rights of the owners or stockholders.

This also provides an additional opportunity to express to the students how important the information contained in the financial statements is to stakeholders of the business. Stakeholders rely on accurate and complete financial information to make decisions relating to the business. The data needed to calculate this ratio come from the financial statements—specifically, the balance sheet.

The equation below is stated in words followed by the figures for Wilson Property Management of Problem 1-1A from its balance sheet used in Objective 5.

$$\begin{array}{lcl} \text{Ratio of Liabilities} & & \text{Total Liabilities} \\ \text{to Owner's Equity} & = & \text{Total Owner's Equity} \\ \text{Ratio of Liabilities} & & \$550 \\ \text{to Owner's Equity} & = & \$37,950 = 0.014 \end{array}$$

To help students understand this concept, ask them to compute their personal ratio and examine how it would change under a variety of different circumstances (such as taking out a student loan on the one hand or winning the lottery on the other).

Use the results to help them learn that the lower the ratio, the better able a business is to withstand poor business conditions and pay its obligations to creditors.

CLASSIC UPHOLSTERY SHOP

Tyler Smith had worked in an upholstery shop for 10 years. Last year, Tyler's wages were \$20,000. Lately, Tyler had been unhappy with the shop's owner. Convinced that he could run an upholstery shop that did better work at a lower cost, Tyler decided to go into business for himself and opened CLASSIC UPHOLSTERY SHOP.

To get the business going, Tyler decided to invest heavily in advertising. He spent \$6,000 on advertising aimed at consumers and another \$2,000 on advertising aimed at getting work from interior decorators and interior design stores. Tyler also purchased industrial sewing machines costing \$4,000 and other tools and equipment costing \$3,000. He estimated that the sewing machines can be used for about five years before maintenance costs will be too high and the machines will need to be replaced. The other tools and equipment are not as durable and will have to be replaced in three years.

At the end of the first year of business, Tyler had received \$80,000 in cash from customers for upholstery work. Tyler was owed another \$2,500 from customers who are not required to pay cash but are billed every 30 days.

A review of Tyler's checkbook shows he paid the following expenses (in addition to those mentioned previously) during the first year of business:

Upholstery fabric	\$40,000
Other supplies	10,000
Wages—part-time assistant	9,500
Rent	4,800
Insurance (two-year policy)	3,200
Utilities	2,500
Miscellaneous expenses	1,700

Tyler's utility bill for the last month of the year has not arrived. He estimates that the bill will be approximately \$320.

Tyler keeps some stock of upholstery fabric in popular colors on hand for customers who do not want to wait for special-order fabric to arrive. At the end of the year, about \$14,000 of the fabric purchased during the year was in his store stock. In addition, \$2,300 in supplies had not been used.

How much profit did Tyler make in his first year of business? Do you think it was a good idea to open the upholstery shop, or would Tyler be better off with his old job?