**Chapter 1: The Financial Statements**

**Learning Objectives**

1. **Explain** why accounting is the language of business
2. **Explain and apply** underlying accounting concepts, assumptions, and principles
3. **Apply** the accounting equation to business organizations
4. **Evaluate** business operations through the financial statements
5. **Construct** financial statements and **analyze** the relationships among them
6. **Evaluate** business decisions ethically

**Questions You Should Be Able To Answer**

|  |  |  |  |
| --- | --- | --- | --- |
| Learning Objective | Question(s) | Answer | For practice |
| 1. Explain why accounting is the language of business | Why is accounting considered the language of business?  What are the ways businesses can be organized? | Accounting communicates economic information. The better you understand accounting, the better you can understand and communicate in business terms.  Proprietorship: sole owner with personal liability  Partnership: more than one owner, often with personal liability  Corporation: more than one owner, with limited liability | S1-7, S1-8, S1-9  S1-3 |
| 1. Explain and apply underlying concepts, assumptions and principles of accounting | Explain the following concepts, assumptions, and principles:   1. Entity assumption 2. Continuity assumption 3. Historical cost principle 4. Stable monetary unit assumption | 1. Each organization is separate   (2) Entity will remain in business  (3) Assets recorded at actual cost  (4) Ignore effects of inflation | S1-4, S1-5,  S1-15 |
| 1. Apply the accounting equation to business organizations | What is the fundamental accounting equation?  What is:   1. An asset? 2. A liability? 3. Stockholders’ (owners’) equity   What are some examples of:   1. Assets 2. Liabilities 3. Stockholders’ equity 4. Revenue 5. Expenses | Assets = Liabilities + Stockholders’ Equity   1. Economic resources expected to benefit the entity in the future 2. Economic obligations, debts 3. Claims held by owners   Cash, accounts receivable, inventories, property and equipment  Accounts payable, notes payable  Common stock, retained earnings  Sales, service revenue  Cost of sales, operating expenses | S1-1; S1-6  S1-8  S1-8 |
| 1. Evaluate business operations through the financial statements | What information is shown in the:   1. Income statement 2. Statement of retained earnings 3. Balance sheet 4. Cash flow statement | (1) Results of operations (revenue – expenses)  (2) What a company did with its earnings  (3) Financial position (assets = liabilities + stockholders’ equity)  (4) The sources of cash inflow (receipts) and outflow (payments) | S1-7, S1-15 |

|  |  |  |  |
| --- | --- | --- | --- |
| 1. Construct financial statements and analyze the relationships among them | What is the most logical order of preparation of the financial statements? | (1) Income statement  (2) Statement of retained earnings  (3) Balance sheet  (4) Statement of cash flows | S1-10, S1-11,  S1-12, S1-13,  S1-14 |
| 1. Evaluate business decisions ethically | What is the proper way to evaluate business decisions ethically? | (1) What is the issue?   1. Who are the stakeholders?   (3) What are the alternatives?  (4) What are the consequences of the decision? | S1-2 |

**Chapter 1 Outline**

1. Accounting – The Language of Business
2. Users of financial information
3. Individuals
4. Investors and creditors
5. Regulatory bodies
6. Nonprofit organizations
7. Financial accounting vs. management accounting
8. Organizing a business
9. Proprietorship
10. Partnership
11. Limited-liability company
12. Corporation
13. Underlying Accounting Concepts, Assumptions, and Principles
14. Financial Accounting Standards Board (FASB)/Generally Accepted Accounting Principles (GAAP)
15. International Accounting Standards Board (IASB)/International Financial Reporting Standard (IFRS)
16. Fundamental qualitative characteristics
17. Relevance
18. Faithful representation
19. Enhancing qualitative characteristics
20. Comparability
21. Verifiability
22. Timeliness
23. Understandability
24. Cost/benefit
25. Entity assumption
26. Continuity (going-concern) assumption
27. Historical cost principle
28. Stable-monetary-unit assumption
29. Application of the Accounting Equation (Assets = Liabilities + Equity)
30. Assets – economic resources with future benefit
31. Liabilities – “outsider claims”
32. Owners’ equity – “insider claims”
33. Paid-in capital
34. Retained earnings
35. Evaluate Business Operations Using the Financial Statements
36. The Income Statement (Revenues – Expenses = Net Income (Net Loss))
37. Revenues
38. Gains
39. Expenses
40. Losses
41. Statement of Retained Earnings (Beginning Retained Earnings + Net Income – Dividends = Ending Retained Earnings)
42. Balance Sheet (Assets = Liabilities + Equity)
43. Assets
    1. Current assets
    2. Non-current assets
44. Liabilities
    1. Current liabilities
    2. Long-term liabilities
45. Stockholders’ equity
46. Statement of Cash Flows (Net cash flow from (Operating Activities + or – Investing Activities + or – Financing Activities) + Beginning Cash balance = Ending Cash balance)
47. Financial Statement Preparation and Analysis of Relationships Among Them
48. Evaluate Business Decisions Ethically
49. The role of judgment
50. Economic factors
51. Legal factors
52. Ethical factors

**Chapter Activities**

**1. Chapter Opener**

Chapter 1 spotlights The Gap, Inc. and details the products the corporation sells, its network of stores, and financial information for the year ended January 28, 2012. Additionally, the section introduces the terms “net sales” and “net income.” Discuss with the students the products that The Gap sells and the prices related to those items. Visit [www.gap.com](http://www.gap.com) and review pricing of those particular products on the company’s website. Explain how these items, once sold, are sales to the company. From the company’s website, you can also download the most current annual report. Use this report to explain the flow of product sales to the financial statements, as well as how that equates to net income.

Additionally, ask the students what information they would need from the financial statements if they had $5,000 to invest. How would they decide if The Gap was a good investment?

**2. Accounts Activity**

On slips of paper, list accounts and distribute one slip of paper to each student. You can use the following chart of accounts as an example:

Cash

Accounts Receivable

Inventory

Prepaid Rent

Office Supplies

Land

Automobiles

Buildings

Patents

Copyrights

Trademark

Accounts Payable

Income Taxes Payable

Interest Payable

Notes Payable

Salaries and Wages Payable

Bonds Payable

Common Stock

Retained Earnings

Sales Revenue

Interest Revenue

Rent Revenue

Advertising Expense

Commissions Expense

Cost of Goods Sold

Depreciation Expense

Income Tax Expense

Insurance Expense

Interest Expense

Salary and Wage Expense

Supplies Expense

Dividends

Dividends Payable

Divide the room up into five areas: assets, liabilities, stockholders’ equity, revenues, and expenses. Ask the students to move to their particular area of the room depending on what account types they have been assigned. Quiz each student to confirm that he or she is in the correct section of the room. Move the students accordingly if they are in the wrong section. Repeat the exercise by dividing the room into a balance sheet section and an income statement section. Again, quiz the students to confirm that they are in the correct area for that particular financial statement and move them, if necessary.

**Difficult Topics**

* Statement of Cash Flows

**Chapter 1: Assignment Grid**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | **(Will have an X if available)** | |
| **Assignment** | **Topic(s)** | **L.O.** | **Estimated Time (minutes)** | **Level of Difficulty** | **Excel Templates** | **General Ledger Templates** |
| S1-1 | Apply the accounting equation | 3 | 5 | Easy |  |  |
| S1-2 | Evaluate business decisions ethically | 6 | 5 | Easy |  |  |
| S1-3 | Explain and differentiate between business organizations | 1 | 10 | Easy |  |  |
| S1-4 | Explain underlying accounting concepts, assumptions, and principles of accounting | 2 | 5 | Easy |  |  |
| S1-5 | Apply underlying accounting concepts, assumptions, and principles | 2 | 5-10 | Easy |  |  |
| S1-6 | Apply the accounting equation | 3 | 5 | Easy |  |  |
| S1-7 | Explain accounting language; evaluate business operations | 1,4 | 5 | Easy |  |  |
| S1-8 | Explain accounting language | 1 | 5-10 | Easy |  |  |
| S1-9 | Explain accounting language | 1 | 5 | Easy |  |  |
| S1-10 | Construct an income statement | 5 | 5 | Easy |  |  |
| S1-11 | Construct a statement of retained earnings | 5 | 5 | Easy |  |  |
| S1-12 | Construct a balance sheet | 5 | 10 | Easy |  |  |
| S1-13 | Construct a statement of cash flows | 5 | 10-15 | Medium |  |  |
| S1-14 | Explain accounting language; construct financial statements | 1,5 | 10 | Easy |  |  |
| S1-15 | Apply accounting concepts; evaluate business activity | 2,4 | 15-20 | Easy |  |  |
| **Assignment** | **Topic(s)** | **L.O.** | **Estimated Time (minutes)** | **Level of Difficulty** | **Excel Templates** | **General Ledger Templates** |
| E1-16A | Apply the accounting equation; evaluate business operations | 3,4 | 10-15 | Medium |  |  |
| E1-17A | Apply the accounting equation; evaluate business operations | 3,4 | 10-15 | Medium |  |  |
| E1-18A | Apply the accounting equation; evaluate business operations | 3,4 | 10-20 | Medium |  |  |
| E1-19A | Identify financial statement by type of information | 5 | 10-15 | Medium |  |  |
| E1-20A | Apply the accounting equation; construct a balance sheet | 3,5 | 10-20 | Medium |  |  |
| E1-21A | Construct an income statement and a statement of retained earnings | 5 | 15-25 | Medium |  |  |
| E1-22A | Construct an income statement and a statement of retained earnings | 5 | 15-20 | Medium | **X** |  |
| E1-23A | Construct a balance sheet | 5 | 15-20 | Medium | **X** |  |
| E1-24A | Construct a statement of cash flows | 5 | 15-20 | Medium |  |  |
| E1-25A | Evaluate business operations through the financial statements | 4 | 10-15 | Medium |  |  |
| E1-26B | Apply the accounting equation; evaluate business operations | 3,4 | 10-15 | Medium |  |  |
| E1-27B | Apply the accounting equation; evaluate business operations | 3,4 | 10-15 | Medium |  |  |
| E1-28B | Apply the accounting equation; evaluate business operations | 3,4 | 10-20 | Medium |  |  |
| E1-29B | Identify financial statement by type of information | 5 | 10-15 | Medium |  |  |
| **Assignment** | **Topic(s)** | **L.O.** | **Estimated Time (minutes)** | **Level of Difficulty** | **Excel Templates** | **General Ledger Templates** |
| E1-30B | Apply the accounting equation; construct a balance sheet | 3,5 | 10-20 | Medium |  |  |
| E1-31B | Construct an income statement and a statement of retained earnings | 5 | 15-25 | Medium | **X** |  |
| E1-32B | Construct an income statement and a statement of retained earnings | 5 | 15-20 | Medium | **X** |  |
| E1-33B | Construct a balance sheet | 5 | 15-20 | Medium |  |  |
| E1-34B | Construct a statement of cash flows | 5 | 15-20 | Medium |  |  |
| E1-35B | Evaluate business operations through the financial statements | 4 | 10-15 | Difficult |  |  |
| Q1-36 to Q1-50 | Practice quiz questions | All | 10-20 | Medium |  |  |
| P1-51A | Apply the accounting equation; evaluate business operations | 3,4 | 30 | Medium |  |  |
| P1-52A | Explain accounting language; apply the accounting equation; evaluate business operations; construct a balance sheet | 1,3,  4,5 | 20-25 | Medium | **X** |  |
| P1-53A | Apply underlying accounting concepts; evaluate business operations; construct a balance sheet | 2,4,5 | 20-25 | Difficult |  |  |
| P1-54A | Construct and analyze an income statement, a statement of retained earnings, and a balance sheet; evaluate business operations | 4,5 | 30-45 | Medium | **X** |  |
| P1-55A | Construct a statement of cash flows; evaluate business operations | 4,5 | 20 | Medium |  |  |
| **Assignment** | **Topic(s)** | **L.O.** | **Estimated Time (minutes)** | **Level of Difficulty** | **Excel Templates** | **General Ledger Templates** |
| P1-56A | Construct financial statements | 5 | 40-50 | Medium |  |  |
| P1-57B | Apply the accounting equation; evaluate business operations | 3,4 | 30 | Medium |  |  |
| P1-58B | Explain accounting language; apply the accounting equation; evaluate business operations; construct a balance sheet | 1,3,  4,5 | 20-25 | Medium | **X** |  |
| P1-59B | Apply underlying accounting concepts; evaluate business operations; construct a balance sheet | 2,4,5 | 20-25 | Difficult |  |  |
| P1-60B | Construct and analyze an income statement, a statement of retained earnings, and a balance sheet; evaluate business operations | 4,5 | 30-45 | Medium | **X** |  |
| P1-61B | Construct a statement of cash flows; evaluate business operations | 4,5 | 20 | Medium |  |  |
| P1-62B | Construct financial statements | 5 | 40-50 | Medium |  |  |
| Decision Case 1 | Explain accounting language; evaluate business operations through financial statements | 1,4 | 30-40 | Medium |  |  |
| Decision Case 2 | Correct errors; construct financial statements; evaluate business operations through financial statements | 4,5 | 20-30 | Medium |  |  |
| Ethical Issue | Evaluate ethical decisions | 6 | 30-40 | Medium |  |  |
| Focus on Financials—Amazon.com | Apply the accounting equation; evaluate business operations | 3,4 | 20-30 | Medium |  |  |
| **Assignment** | **Topic(s)** | **L.O.** | **Estimated Time (minutes)** | **Level of Difficulty** | **Excel Templates** | **General Ledger Templates** |
| Focus on Analysis—Yum! Brands, Inc. | Apply the accounting equation; evaluate business operations | 3,4 | 30 | Medium |  |  |
| Group Project 1 | Bank Loan | All | 45-60 | Difficult |  |  |
| Group Project 2 | Going Public | All | 45-60 | Difficult |  |  |

**Answer Key to Chapter 1 Quiz (Quiz on following pages.)**

1. A

2. C

3. B

4. C

5. B

6. D

7. A

8. A

9. D

10. C

Name\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Date\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Section\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Chapter 1**

**10-Minute Quiz**

**Circle the letter of the best response.**

1. The equation for the Statement of Cash Flows is:

A. Net cash flow from (Operating Activities + or – Investing Activities + or – Financing Activities) + Beginning Cash balance = Ending Cash balance

B. Net cash flow from (Operating Activities – Investing Activities – Financing Activities) + Beginning Cash balance = Ending Cash balance

C. Net cash flow from (Operating Activities + Investing Activities + Financing Activities) – Beginning Cash balance = Ending Cash balance

D. Net cash flow from (Operating Activities – Investing Activities + Financing Activities) + Ending Cash balance = Beginning Cash balance

2. Which item is an asset?

A. Long-Term Debt

B. Accounts Payable

C. Accounts Receivable

D. Notes Payable

3. If total liabilities decreased by $75,000 and total assets decreased by $90,000 during the same accounting time period, what happened to total owners’ equity during this period?

A. $15,000 increase

B. $15,000 decrease

C. $90,000 increase

D. $90,000 decrease

4. Assuming an entity will continue to operate long enough to sell its inventories and convert any receivables to cash is:

A. Stable-monetary-unit assumption.

B. Entity assumption.

C. Continuity (going-concern) assumption.

D. Historical cost principle.

5. Which financial statement reports net income and dividends?

A. Income Statement

B. Statement of Retained Earnings

C. Balance Sheet

D. Statement of Cash Flows

6. The \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ states that assets should be recorded at their actual cost.

A. Stable-monetary-unit assumption

B. Continuity (going-concern) assumption

C. Entity assumption

D. Historical cost principle

7. Which financial statement reports revenues and expenses?

A. Income Statement

B. Statement of Retained Earnings

C. Balance Sheet

D. Statement of Cash Flows

8. Mr. Ronald Smith is the owner of a small business. He has decided to save money during his initial years of operation by not hiring a professional accountant. He makes inflation adjustments to accounting information to make it comparable over time. Which accounting principle, concept, or assumption does this violate?

A. Stable-monetary-unit assumption

B. Continuity (going-concern) assumption

C. Entity assumption

D. Historical cost principle

9. Listed below are the account balances of the Arthur Frank Corporation:

|  |  |
| --- | --- |
| Accounts Payable | $ 75,000 |
| Cash | 100,000 |
| Common Stock | 500,000 |
| Dividends | 50,000 |
| Land | 60,000 |
| Miscellaneous Expense | 3,000 |
| Service Revenue | 250,000 |
| Equipment | 40,000 |
| Note Payable due in 60 days | 125,000 |

|  |  |
| --- | --- |
| Long-Term Debt | 13,000 |
| Salary Expense | 120,000 |

Total Liabilities are:

A. $100,000.

B. $338,000.

C. $278,000.

D. $213,000.

10. Listed below are the account balances of the Arthur Frank Corporation:

|  |  |
| --- | --- |
| Accounts Payable | $ 75,000 |
| Cash | 100,000 |
| Common Stock | 500,000 |
| Dividends | 50,000 |
| Land | 60,000 |
| Miscellaneous Expense | 3,000 |
| Service Revenue | 250,000 |
| Equipment | 40,000 |
| Note Payable due in 60 days | 125,000 |
| Long-Term Debt | 13,000 |
| Salary Expense | 120,000 |

Net Income is:

A. $263,000.

B. $150,000.

C. $127,000.

D. $120,000.