Chapter 1

Accounting and the Business Environment

Chapter Overview

The chapter begins with an introduction to accounting, and a brief description on why accounting is important. The differences between financial and managerial accounting are discussed very briefly. The text discusses how accounting information is needed by various users—individuals, businesses, investors, creditors, and taxing authorities. The accounting profession and career paths available to accounting majors are briefly described. The sole proprietorship, partnership, corporations, and limited liability companies (LLCs) forms of business are briefly described. However, the focus of this text is the accounting for corporations. The role of governing organizations such as the Financial Accounting Standards Board (FASB), Securities and Exchange Commission (SEC), and International Accounting Standards Board (IASB) are explained. Generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) are introduced. The economic entity assumption, cost principle, going concern assumption, and monetary unit assumption are explained. The role of ethics in accounting is described. The U.S. government’s passing of the Sarbanes-Oxley Act (SOX), as well as the creation of the Public Company Accounting Oversight Board (PCAOB), are presented.

The next section of the chapter introduces the accounting equation: Assets = Liabilities + Equity. Each element of the equation is defined. Examples of a variety of transactions are analyzed, and their impact on the accounting equation is discussed. The financial statements—income statement, statement of retained earnings, balance sheet, and statement of cash flows are illustrated. The interrelationship of the financial statements is emphasized. An ethics sidebar helps give perspective on real world ethical dilemmas. Financial statements and return on assets (ROA) are used to evaluate business performance. A decisions sidebar helps students see how financial statements and ROA can be used to make real world decisions. A review highlights the information students should have acquired from the chapter. A summary problem allows students to record the effect of transactions on the accounting equation, prepare financial statements, and calculate ROA. A quick check gives students a chance to assess their knowledge of the chapter learning objectives.

**Learning Objectives**

1. Explain why accounting is important and list the users of accounting information
2. Describe the organizations and rules that govern accounting
3. Describe the accounting equation, and define assets, liabilities, and equity
4. Use the accounting equation to analyze transactions
5. Prepare financial statements
6. Use financial statements and return on assets (ROA) to evaluate business performance

**Chapter 1: Teaching Outline**

1. Explain why accounting is important and list the users of accounting information
   1. Define the term accounting
   2. Exhibit 1-1 Decision Making: Financial versus Managerial Accounting
   3. Define the following users of financial information:
      1. Individuals
      2. Businesses
      3. Investors
      4. Creditors
      5. Taxing Authorities
   4. Describe career options and certifications available to accounting majors

i) Exhibit 1-2 Comparison of Accounting Positions

1. Describe the organizations and rules that govern accounting
   1. Identify the different types of business organizations
      1. Sole Proprietorship
      2. Partnership
      3. Corporation
      4. Limited-Liability Company (LLC)
      5. Exhibit 1-3 Business Organizations
   2. Define the Governing Organizations
      1. Financial Accounting Standards Board (FASB)
         1. Generally Accepted Accounting Principles (GAAP)

The Economic Entity Assumption

1. Exhibit 1-4 Structure of a Corporation

The Cost Principle

The Going Concern Assumption

The Monetary Unit Assumption

* + 1. Securities and Exchange Commission (SEC)
    2. International Accounting Standards Board (IASB)
       1. International Financial Reporting Standards (IFRS)
  1. Ethics in Accounting and Business
     1. Sarbanes-Oxley Act (SOX)
     2. Public Company Accounting Oversight Board (PCAOB)

1. Describe the accounting equation, and define assets, liabilites, and equity
   1. The accounting equation
   2. Assets, Liabilities, Equity
2. Use the accounting equation to analyze transactions
   1. Exhibit 1-5 Analysis of Transactions, Smart Touch Learning
3. Prepare financial statements
   1. The Four Financial Statements
      1. Income Statement: Exhibit 1-6 Income Statement
      2. Statement of Retained Earnings: Exhibit 1-7 Statement of Retained Earnings
      3. Balance Sheet: Exhibit 1-8 Balance Sheet
      4. Statement of Cash Flows: Exhibit 1-9 Statement of Cash Flows
4. Use financial statements and return on assets (ROA) to evaluate business performance
   1. Exhibit 1-10 Information Provided by Financial Statements
   2. Explain return on assets (ROA)
   3. Return on Assets = Net Income/Average Total Assets

Chapter 1: Summary Handout for Students

1. Accounting equation: ASSETS = LIABILITIES + EQUITY

* Assets are something the business owns, or has control of, that has value
* Liabilities are something the business owes
* Equity represents the amount of assets that are left over after the company has paid its liabilities, or net worth

1. Transaction analysis using the accounting equation

* *Key*: Both sides of the accounting equation must always be equal

1. Four financial statements

* Income Statement
* Statement of Retained Earnings
* Balance Sheet (uses the same accounts as the accounting equation)
* Statement of Cash Flows
* Headings on statements always listed as:
* Name of company
* Name of statement
* Descriptive date

1. Return on Assets: Net income /Average total assets

* Average total assets = (Beginning total assets + Ending total assets) / 2

Chapter 1: Lecture Outline Tips: Key Topics

The stockholders of a company may be (and probably are) officers as well. Not all investors are “outside” of the company. The financial statements are the primary tools for providing information to outside investors; but officers also use the statements, along with other financial information, to manage the company on a day-to-day basis.

Financial accounting deals with historical information—the company reports on events that have already occurred. Statements dated as “ended” indicate historical information.

All companies, public and private, can follow GAAP. However, this may not be a requirement for private companies. These companies can use other bases of accounting, such as the cash basis, unless GAAP is required due to an audit. There is also a difference between record keeping and financial statement preparation. Companies can keep their accounting records on another basis and convert the financial statements to GAAP. For example, small private companies may use the cash basis for record keeping and convert to the accrual basis for financial statement preparation. The SEC is currently investigating endorsing IFRS. If the SEC endorses IFRS, then IFRS will be slowly incorporated into the U.S. financial system. This could mean that in the future, U.S. GAAP will be in-line with IFRS, and reporting under IFRS could start as early as 2015 or 2016.

Not all accountants are licensed, and those that are, may not necessarily be members of the AICPA and IMA, the professional associations described in the textbook. However, the licensing board (if a license has been granted) and/or federal and state laws can still be applied to hold people accountable for their actions.

The Sarbanes-Oxley Act and the PCAOB relate to public companies. As a rule, public companies are more regulated (related to accounting information) than private companies. Some companies are now going private; and one reason for doing so may be to reduce the compliance cost associated with these additional regulations.

Corporate status is not based on the size of the company. Not all large companies are corporations and not all small companies are sole proprietorships and partnerships. A corporation could have only one stockholder. Why would a one-shareholder business incorporate the business in this case? One reason is limited liability protection. Regardless of the number of stockholders, all corporations follow the same general corporate procedures.

Information presented in the financial statements is largely based on historical cost—the cost principle. Beginning students may think the balance sheet total represents the value of the company, which is incorrect. The balance sheet total is based on historical cost and may not represent the fair market value of the company as of the statement date. For example, land purchased 10 years ago is likely to be worth more than the original cost, but it would still be reported on the balance sheet at original cost. These types of assets are sometimes called “hidden assets”; the true value is not reflected on the financial statement. Some students may think a company is worth the amount of its total assets. This is incorrect—don’t forget about subtracting liabilities! The equity total represents the true value of the company.

The accounting equation must always balance. Most textbook examples show companies that are profitable from the very beginning and always have positive equity balances. You could also have a transaction that affects only one side of the equation (left or right), but the equation would still balance. For example, a transaction could increase one asset and decrease another asset and the equation would balance with no effect on liabilities and equity. A company that purchases supplies with cash would experience this.

Students sometimes have trouble understanding the purchase of supplies on account, and how the usage of the supplies and the payment of the outstanding liability relate to each other. Students may want to decrease the outstanding liability as the asset is used up, which is incorrect. These are three separate events: (1) purchasing an asset, (2) using the asset, and (3) paying the outstanding liability.

It may be worthwhile to introduce the concept of materiality at this point: Is an item large or important enough to influence a person’s perspective or decision about the company? In many cases, the accounting process and financial reporting is not “to the penny,” although students may think this is the case. One example would be the accounting for supplies. Theoretically, supplies are an asset and should be recorded as such. The asset would turn into an expense as the supplies are used over time. However, in practice, some companies expense supplies immediately because the balance is immaterial to the overall financial statements. Another example of materiality is the fact that many financial statements are rounded for presentation purposes. Some large companies present statements in thousands or millions of dollars. It’s interesting to provide examples of real company financial statements to students early in the semester and see their reaction to this type of rounding.

Net income and cash flow are separate concepts; both are not always positive. A company could have net income and negative cash flow, as well as net loss and positive cash flow. Many creditors will focus on cash flow in order to determine if a company can generate cash in order to pay back any outstanding liabilities.

Each of the financial statements required by GAAP focuses on a different area. All four statements should be analyzed in order to get a complete picture of a company. The income statement tracks profitability; remember that “profit” doesn’t necessarily mean “money”—the profit may not have been collected in cash yet. The statement of retained earnings shows the changes in retained earnings during a period of time. As profits increase, the equity should increase as well. The balance sheet shows a company’s financial position at a certain point in time. Notice this is for one day only—the balance sheet will probably change the day after it’s prepared. Financial position (the balance sheet) is different from profitability (the income statement). A company could be very profitable and do a terrible job of managing its profits, or vice versa. Students probably know a person that is like this! Some people have high-income levels and end up with very little net worth because they can’t manage their finances. On the other hand, some people have modest income levels and do a very good job of managing their finances. The cash flow statement shows how the company is generating and using its cash. Students may have heard the phrase “cash is king”; a company must have cash to pay its outstanding bills. Some recent accounting fraud cases involved companies that reported great profits, but no corresponding cash flow—a possible red flag!

Every transaction affects the balance sheet—an asset, liability, or equity account is affected in any business transaction. A transaction may or may not affect the other financial statements.

Students should understand the proper ordering of financial statement preparation. They will quickly learn this when attempting to prepare financial statements, if they don’t have the numbers they need to continue going forward. For example, try to complete a retained earnings statement before preparing the related income statement. Ending retained earnings cannot be calculated without considering net income or net loss from the income statement. In addition, headings and currency signs are very important. This is something students can “glaze over.” Each statement should have a company name, a statement title, and a date. The balance sheet is as of one day, and the other statements cover a period of time. If students prepare a balance sheet dated for the entire period, ask them to think about how to determine a cash balance for a period of time. This can’t be done—a balance is computed for a certain date, not for a period of time. For example, a company could have a $10,000 cash balance as of 12/31/11, but not a $10,000 balance for the year ended 12/31/11—the balance could change every day.

Currency signs indicate a unit of measurement for the reader of the statement, and can be used for comparison purposes. Lastly, although in many textbooks the standard reporting practice is annually, students should realize that companies may report for a variety of different accounting periods—monthly, quarterly, semi-annually, annually, etc. The reporting period would be indicated in the statement heading.

# Chapter 1 Assignment Grid

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Learning Objective** | **Short Exercises**  ***Easy*** | **Exercises**  ***Moderate*** | **Problems (Group A) *Difficult*** | **Problems (Group B) *Difficult*** |
| 1 | 1 | 17 |  |  |
| 2 | 2, 3, 4, 5 | 18 |  |  |
| 3 | 6, 7, 8 | 19, 20, 21, 22, 23, 24 |  |  |
| 4 | 9, 10 | 25, 26, 27, 28, 29 | 40, 41, 45, 46 | 47, 48, 52, 53 |
| 5 | 11, 12, 13, 14, 15 | 19, 30, 31, 32, 33, 34, 35, 36, 37, 38 | 42, 43, 44, 45, 46 | 49, 50, 51, 52, 53 |
| 6 | 16 | 39 |  |  |

**Other End of Chapter Materials:**

|  |
| --- |
| Continuing Problem P1-54 |
| Decision Case 1-1 |
| Decision Case 1-2 |
| Ethical Issue 1-1 |
| Fraud Case 1-1 |
| Financial Statement Case 1-1 |
| Team Project 1-1 |
| Team Project 1-2 |
| Communication Activity 1-1 |

*Answer Key to Chapter 1 Quiz:*

|  |  |
| --- | --- |
| 1. B  2. A  3. D  4. B  5. B | 6. D  7. C  8. C  9. D  10. B |

Name Date Section

**CHAPTER 1**

**TEN-MINUTE QUIZ**

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

1. Generally accepted accounting principles (GAAP) are formulated by the
   1. American Institute of Certified Public Accountants (AICPA)
   2. Financial Accounting Standards Board (FASB)
   3. International Accounting Standards Board (IASB)
   4. Securities and Exchange Commission (SEC)
2. Which type of business organization is owned by one owner?
3. Proprietorship
4. Partnership
5. Corporation
6. Items a, b, and c are all correct
7. Which accounting assumption assumes that an entity will remain in operation for the foreseeable future?
8. Economic entity assumption
9. Cost principle
10. Monetary unit assumption
11. Going concern assumption
12. Red Door Boutique is famous for fashion wristwatches and leather purses. At the end of a recent year, Red Door’s total assets added up to $485,000, and liabilities were $163,000. How much was Red Door’s equity?
13. $163,000
14. $322,000
15. $485,000
16. Cannot determine from the data given
17. Assume that Red Door Boutique sold additional watches to a department store on account for $58,000. How would this transaction affect Red Door’s accounting equation?
18. Increase both assets and liabilities by $58,000
19. Increase both assets and equity by $58,000
20. Increase both liabilities and equity by $58,000
21. No effect on the accounting equation because the effects cancel out
22. Accounting is the information system that
23. communicates the results to decision-makers.
24. measures business activity.
25. processes data into reports.
26. does all of the above.
27. Which of the following is not an external user of a business’s financial information?
28. Taxing authorities
29. Customers
30. Employees
31. Investors
32. Consider the overall effects on Red Door Boutique of selling watches and purses on account for $75,000 and paying expenses totaling $48,000. What is Red Door’s net income or net loss?
33. Net income of $75,000
34. Net loss of $27,000
35. Net income of $27,000
36. Cannot determine from the data given
37. The income statement reports
38. financial position on a specific date.
39. results of operations on a specific date.
40. financial position for a specific period.
41. results of operations for a specific period.
42. On the 2011 income statement, Red Door Boutique reported net income of $123,000. The company reported beginning total assets of $2,056,000 and ending total assets of $2,182,000. What is Red Door’s return on assets for 2011?
43. 5.6%
44. 5.8%
45. $2,182,000
46. Cannot determine from the data given