cHAPTER 1

Accounting in Business

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| Related Assignment Materials | | | | | |
| **Student Learning Objectives** | **Questions** | **Quick Studies\*** | **Exercises\*** | **Problems\*** | **Beyond the Numbers** |
| **Conceptual objectives** | | | | | |
| C1. Explain the purpose and importance of accounting | 1, 5, | 1-1 | 1-1, 1-4, 1-6 |  | 1-6 |
| C2. Identify users and uses of, and opportunities in accounting. | 2, 3, 4, 6, 7,  8, 9, 10, 11,  12, 23 | 1-2 | 1-2, 1-3, 1-4 |  | 1-4, 1-8 |
| C3. Explain why ethics are crucial to accounting. | 11, 12, 14 | 1-3 | 1-4, 1-5 |  | 1-3 |
| C4. Explain the meaning of generally accepted accounting principles, and define and apply several key accounting principles. | 13, 14, 15,  16, 19, 32 | 1-4, 1-5,  1-6, 1-16,  1-17 | 1-6, 1-7 | 1-7, 1-8, 1-9 | 1-3 |
| C5. B Identify and describe the three major activities in organizations. (Appendix 1B) | 14, 16, 30,  31 |  | 1-21 | 1-13, 1-14 |  |
| **Analytical objectives:** | | | | | |
| A1. Define and interpret the accounting equation and each of its components. | 17, 33, 34 | 1-7, 1-8,  1-9 | 1-8, 1-9 | 1-1, 1-2,  1-8, 1-10 | 1-1, 1-2,  1-4, 1-7,  1-9 |
| A2. Compute and interpret return on assets. | 28 | 1-14 | 1-18 | 1-10, 1-11 | 1-1, 1-2,  1-5, 1-9 |
| A3. A Explain the relation between return and risk. (Appendix 1A) | 29 |  |  | 1-12 | 1-1, 1-2,  1-9 |
| **Procedural objectives:** | | | | | |
| P1. Analyze business transactions using the accounting equation. | 18 | 1-10, 1-11 | 1-10, 1-11,  1-12, 1-13 | 1-1, 1-2, 1-7,  1-8, 1-9 | 1-7 |
| P2. Identify and prepare basic financial statements and explain how they interrelate. | 20, 21, 22,  23, 24, 25,  26, 27, 28,  33, 35 | 1-12, 1-13,   1-14 | 1-14, 1-15,  1-16, 1-17,  1-18, 1-19,  1-20 | 1-3, 1-4, 1-5,  1-6, 1-7, 1-8,  1-9 |  |

***\*See additional information on next page that pertains to these quick studies, exercises and problems.***

# Additional Information on Related Assignment Material

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| ***Connect*** (Available on the instructor’s course-specific website) repeats all numerical Quick Studies, all Exercises and Problems Set A. ***Connect*** provides new numbers each time the Quick Study, Exercise or Problem is worked. It allows instructors to monitor, promote, and assess student learning. It can be used in practice, homework, or exam mode**.** |
| **The Serial Problem** for *Success Systems* starts in this chapter and continues throughout many chapters of the text. It is most readily solved manually if you use the working papers that accompany text. |

# Synopsis of Chapter Revisions

* Apple: NEW opener with new entrepreneurial assignment
* Added titles to revenue and expense entries in columnar layout of transaction analysis
* Streamlined section on Dodd-Frank act
* Bulleted presentation for accounting principles
* Deleted world map of IFRS coverage
* Bulleted layout for 'fraud triangle'
* New discussion on FASB and IASB convergence.
* Updated return on assets for Dell

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| Chapter Outline | Notes |
| 1. **Importance of Accounting**—we live in the information age, where information, and its reliability, impacts the financial well-being of us all. |  |
| 1. Accounting Activities *Accounting* is an information and measurement system that identifies, records and communicates relevant, reliable, and comparable information about an organizations business activities. |  |
| 1. Users of Accounting Information |  |
| 1. External Information Users—those *not* directly involved with running the company. Examples: shareholders (investors), lenders, directors, external auditors, non-executive employees, labor unions, regulators, voters, legislators, government officials, customers, suppliers, lawyers, brokers, etc. |  |
| 1. Financial Accounting—area of accounting aimed at serving external users by providing them with *general-purpose financial statements*. 2. General-Purpose Financial Statements—statements that have broad range of purposes which external users rely on. |  |
| 2. Internal Information Users—those directly involved in managing and operating an organization. |  |
| 1. Managerial Accounting—area of accounting that serves the decision-making needs of internal users. 2. Internal Reports—not subject to same rules as external reports. They are designed with special needs of external users in mind. |  |
| C. Opportunities in Accounting Four broad areas of opportunities are financial, managerial, taxation, and accounting related. |  |
| 1. Private accounting offers the most opportunities.  2. Public accounting offers the next largest number of opportunities  3. Government (and not-for-profit) agencies, including business regulation and investigation of law violations also offer opportunities. |  |
| **II.** **Fundamentals of Accounting**—accounting is guided by principles, standards, concepts, and assumptions. |  |
| A. Ethics—a key concept. Ethics are beliefs that distinguish right from wrong.  B. Fraud Triangle—model that asserts three factors must exist for person to commit fraud: opportunity, pressure, and rationalization. |  |

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| Chapter Outline | Notes |
| C. Internal Controls—procedures set up to protect company property and equipment and insure reliable accounting reports, promotes efficiency, and encourage adherence to company policies.  D. Generally Accepted Accounting Principles (GAAP)—concepts and rules that govern financial accounting. Purpose of GAAP is to make information in accounting statements relevant, reliable and comparable. |  |
| 1. Setting Accounting Principles |  |
| a. In U.S. major rule-setting bodies are the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB). SEC delegated authority to set U.S. GAAP to the FASB. |  |
| b. The International Accounting Standards Board (IASB) issues standards (International Financial Reporting Standards or IFRS) that identify preferred accounting practices in the global economy. IASB hopes to create harmony among accounting practices in different countries.  c. Differences between U.S. GAAP and IFRS are decreasing as the FASB and IASB pursue convergence. |  |
| 1. Conceptual Framework and Convergence—The FASB and IASB are attempting to converge and enhance the conceptual framework that guides standard setting. Framework consists of: |  |
| 1. Objectives—to provide information useful to investors, creditors, and others. 2. Qualitative Characteristics—to require information that is relevant, reliable and comparable. 3. Elements—to define items that financial statements can contain. 4. Recognition and Measurement—to set criteria that an item must meet for it to be recognized as an element; and how to measure that element. |  |
| 1. Principles and Assumptions of Accounting—two types are *general principles* (basic assumptions, concepts and guidelines for preparing financial statements; stem from long used accounting practices) and *specific principles* (detailed rules used in reporting transactions; from rulings of authoritative bodies). The four principles discussed in this chapter are: |  |

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| 1. *Measurement principle also called the cost principle*—financial statements are based on actual costs (with a potential for subsequent adjustments to market) incurred in business transactions. Cost is measured on a cash or equal-to-cash basis. This principle emphasizes reliability and verifiability; information based on cost is considered objective. *Objectivity* means information is supported by independent unbiased evidence: more than someone's opinion. |  |
| 1. *Revenue recognition principle*—revenue is recognized (recorded) when earned. Proceeds need not be in cash. Revenue is measured by cash received plus the cash value of other items received. 2. *Expense recognition principle, also called matching principle*—prescribes that a company records expenses incurred to generate revenues it reported. 3. *Full disclosure principle*—prescribes reporting the details behind the financial statements that would impacts users’ decisions; often in footnotes to the statements. |  |
| The four assumptions discussed in this chapter are:  a. *Going-concern assumption*—accounting information reflects the assumption that the business will continue operating instead of being closed or sold.  b. *Monetary unit assumption*—transactions and events are expressed in monetary, or money, units. Generally this is the currency of the country in which it operates but today some companies express reports in more than one monetary unit. |  |
| c. *Time period assumption*—the life of the company can be divided into time periods, such as months and years, and that useful reports can be prepared for those periods. |  |
| d. *Business entity assumption*—a business is accounted for separate from other business entities and separate from its owner. Necessary for good decisions |  |
| 4. Business Entity Legal Forms |  |
| a*.* *Sole proprietorship* is a business owned by one person that has unlimited liability. It is a separate entity for accounting purposes. The business is not subject to an income tax but the owner is responsible for personal income tax on the net income of entity. |  |
| b. *Partnership* is a business owned by two or more people, called partners, who aresubject to unlimited liability. The business is not subject to an income tax, but the owners are responsible for personal income tax on their individual share of the net income of entity. |  |
| Chapter Outline | Notes |
| c. Three special partnership forms that limit liability |  |
| 1. Limited partnership (LP)—has a general partner(s) with unlimited liability and a limited partner(s) with limited liability restricted to the amount invested. 2. Limited liability partnership (LLP)—restricts partner’s liabilities to their own acts and the acts of individuals under their control. 3. Limited liability company (LLC)—offers the limited liability of a corporation and the tax treatment of a partnership.(Note: most proprietorships and partnerships are now organized as LLC) |  |
| 1. *Corporation* is a business that is a separate legal entity whose owners are called shareholders or stockholders. These owners have limited liability. The entity is responsible for a business income tax and the owners are responsible for personal income tax on profits that are distributed to them in the form of dividends. |  |
| 1. Accounting Constraints There are two basic constraints on financial reporting. |  |
| 1. The *materiality* constraint prescribes that only information that would influence the decisions of a reasonable person need be disclosed. It looks at both the importance and relative size of an amount. 2. The *cost-benefit* constraint prescribes that only information with benefits of disclosure greater than the costs of providing it need be disclosed. 3. *Conservatism* and *industry practices* are sometimes referred to as constraints as well. |  |
| 6. Sarbanes-Oxley (SOX)—Law passed by congress that requires public companies to apply both accounting oversight and stringent internal controls to achieve more transparency, accountability and truthfulness in reporting.  7. Dodd-Frank (Wall Street Reform and Consumer Protection Act)—Law recently passed as a response to financial systems near collapse. Details of the law are yet to be set forth by regulators. |  |
| **III. Transactions Analysis and the Accounting Equation** |  |
| A. Accounting equation (Assets = Liabilities + Equity)—elements of the equation include: |  |
| 1. Assets—resources a company owns or controls that are expected to carry future benefits. (i.e. cash, supplies, equipment and land) 2. Liabilities—creditors’ claims on assets. These claims reflect obligations to transfer assets or provide products or services to others. |  |
| Chapter Outline | Notes |
| 3. Equity—owner’s claim on assets; assets minus liabilities. Also called *net assets* or *residual equity.* Changes in Equity—result from investments, revenues, withdrawals, expenses. |  |
| 1. Investments—assets an owner puts into the company results in an increase in equity. Recorded under the title *Owner, Capital*. 2. Revenues—are sales of products or services to customers. Revenues increase equity (via net income) and result from a company’s earnings activities. |  |
| 1. Owner’s withdrawals—assets an owner takes from the company for personal use (results in decrease in equity). 2. Expenses—cost of assets or services used to earn revenues (results in decrease in equity). |  |
| 1. Expanded Accounting Equation:   Assets = Liabilities + Owner’s Capital – Owner’s Withdrawal + Revenues – Expenses |  |
| 1. Transaction Analysis—each transaction and event always leaves the equation in balance. (Assets = Liabilities + Equity) |  |
| 1. Investment by owner:   ASSET = LIABILITIES + OWNERS’ EQUITY  **+ Cash + Owner Name, Capital**   *reason: investment*  Increase on both sides of equation-- keeps equation in balance.   1. Purchase supplies for cash:   ASSET = LIABILITIES + OWNERS’ EQUITY **+ Supplies**  **- Cash** Increase and decrease on one side of the equation keeps the equation in balance.   1. Purchase equipment for cash:   ASSET = LIABILITIES + OWNERS’ EQUITY **+ Equipment**  **– Cash** Increase and decrease on one side of the equation keeps the equation in balance.   1. Purchase supplies on credit:   ASSET = LIABILITIES + OWNERS’ EQUITY **+ Supplies + Accounts Payable**  Increase on both sides of equation keeps equation in balance. |  |
| Chapter Outline | Notes |
| 1. Provide services for cash:  ASSET = LIABILITIES + OWNERS’ EQUITY **+ Cash + Revenue Earned** Increase on both sides of equation keeps equation in balance.   6. Payment of expense in cash (salaries, rent etc.):  ASSET = LIABILITIES + OWNERS’ EQUITY **- Cash - (+ Expense)**  Decrease on both sides of equation keeps equation in balance.  7. Provided services and facilities for credit:  ASSET = LIABILITIES + OWNERS’ EQUITY **+ Acct. Rec. + Revenue Earned**  Increase on both sides of equation keeps equation in balance.  8. Receipt of cash from account receivable (customers paying on their accounts):  ASSET = LIABILITIES + OWNERS’ EQUITY  **+ Cash**  **- Acct. Rec**  Increase and decrease on one side of the equation keeps the equation in balance. |  |
| 9. Payment of accounts payable:  ASSET = LIABILITIES + OWNERS’ EQUITY  **- Cash - Accounts Payable**  Decrease on both sides of equation keeps equation in balance. |  |
| 10. Withdrawal of cash by owner:  ASSET = LIABILITIES + OWNERS’ EQUITY  **- Cash - (+ Owner Name, Withdrawal)**  Decrease on both sides of equation keeps equation in balance.(note: since withdrawals are not expenses they are not used in computing net income.) |  |

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| Chapter Outline | Notes |
| |  | | --- | | **IV. Financial Statements** | | A. The four financial statements and their purposes are: | | 1*.* *Income Statement*—describes a company’s revenues and expenses along with the resulting net income or loss over a period of time. (Net income occurs when revenues exceed expenses. Net loss occurs when expenses exceed revenues.)  2*.* *Statement of Owner’s Equity*—explains changes in equity from net income (or loss) and from owner investment and withdrawals over a period of time. | | 3*.* *Balance Sheet*—describes a company’s financial position (types and amounts of assets, liabilities, and equity) at a point in time.  4. *Statement of Cash Flows*—identifies cash inflows (receipts) and cash outflows (payments) over a period of time. | | B. Statement Preparation from Transaction Analysis—prepared in the following order using the *procedure* indicated below. | | 1. Income Statement⎯information about revenues and expenses is conveniently taken from the owner's equity column. Total revenues minus total expenses equals net income or loss. Notice that owner’s withdrawals and investments are not part of measuring income or loss.  2. Statement of Changes in Owner’s Equity⎯the beginning owner’ equity is taken from the owner’s equity column and any investments of owner are added. The net income, from the income statement is added (or the net loss is subtracted) and finally the owner’s withdrawals are subtracted to arrive at the ending capital. Ending capital is carried to the Balance Sheet.   |  | | --- | | 3. Balance Sheet⎯the ending balance of each asset is listed and the total of this listing equals total assets. The ending balance of each liability is listed and the total of this listing equals total liabilities. The ending capital (note that this is taken from the statement of owner’s equity), is listed and added to total liabilities to get total liabilities and owner’s equity. This total must agree with total assets to prove the accounting equation. Either the *account form* or the *report form* may be used to prepare the balance sheet. | | 4. Statement of Cash Flows⎯the cash column must be carefully analyzed to organize and report cash flows in categories of operating, investing, and financing. The net change in cash is determined by combining the net cash flow in each of the three categories. This change is combined with the beginning cash. The resulting figure should be the ending cash that was shown on the balance sheet. | | |  |

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| Chapter Outline | Notes |
| |  | | --- | | **V. Global View—**Financial Accounting using U.S. GAAP is similar, but not identical to IFRS. Similarities and differences: | | 1. Basic Principles—both GAAP and IFRS include broad and similar guidance for accounting. 2. Transaction Analysis—identical as shown in this chapter. Later, some differences will arise. GAAP is rules-based whereas IFRS is more principles-based. 3. Financial Statements—both systems require preparation of the same four basic financial statements | | **VI. Decision Analysis—Return on Assets (ROA)—**a profitability measure. Also called Return on Investment (ROI) | | A. Useful in evaluating management, analyzing and forecasting profits, and planning activities.  B. The return on assets is: calculated by dividing net income for a period by average total assets. (Average total assets is determined by adding the beginning and ending assets and dividing by 2.)  C. As with all analysis tools, results should be compared to previous business results as well as competitor’s results and industry norms. | | **VII.** **Risk and Return Analysis—Appendix 1A** | | A. Risk—the uncertainty about the return we will earn on an investment.  B. The lower the risk, the lower the return.  C. Higher risk implies higher, but riskier implied returns. |   **VIII.** **Business Activities and the Accounting Equation—Appendix 1B** |  |
| A. The accounting equation is derived from business activities.  B. Three major business activities are: |  |
| 1. Financing activities—activities that provide the means organizations use to pay for resources such as land, buildings, and equipment to carry out plans. Two types of financing are: |  |
| a. Owner financing—refers to resources contributed by owner including income left in the organization.  b. Non-owner (or creditor) financing—refers to resources contributed by creditors (lenders). |  |
| 2. Investing activities—are the acquiring and disposing of resources (assets) that an organization uses to acquire and sell its products or services.  3. Operating activities—involve using resources to research, develop, purchase, produce, distribute, and market products and services. |  |
| C Investing (assets) is balanced by Financing (liabilities and equity). Operating activities is the result of investing and financing. |  |

# VISUAL #1-1

## WARNING: NO MATTER WHAT HAPPENS

## ALWAYS KEEP THIS SCALE

## IN BALANCE



## Basic Accounting Equation

## ASSETS = LIABILITIES + OWNER’S EQUITY

## TRANSACTION ANALYSIS RULES

1) Every transaction affects at least two items.

2) Every transaction must result in a balanced equation.

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| TRANSACTION ANALYSIS POSSIBILITIES: | | | | | | |
| A | | = | L | + | OE |
| (1) | + | and | + | | |
| OR(2) | - | and | - | | |
| OR(3) | + and - | and | No change | | |
| OR(4) | No change | and | + and - | | |