# Chapter 1: Overview

# Business, Accounting, and You

The chapter begins with a discussion of understanding the role of business. **Accounting** is the process of recognizing, measuring, recording, and reporting information about a business. **Business** is defined as a legal organization that attempts to create value by exchanging products with customers for money. There is a discussion of the concept of value. Key terms and stakeholders are defined.

Following, there is a discussion that focuses on how a business operates and the resources needed to start a business. The cost of money is covered.

In the next section of the chapter, two categories of business are reviewed—for-profit business and not-for-profit. Three types of businesses are introduced: service, merchandising, and manufacturing. The legal forms of business organizations are explained. The advantages and disadvantages of four forms of business organizations (sole proprietorship, partnership, corporation, and limited liability company) are briefly discussed. The “S-corporation” election is also mentioned.

The text discusses the accounting principles and concepts that govern financial accounting. Generally Accepted Accounting Principles (GAAP), the business entity principle, the reliability (objectivity) principle, and the cost principle are explained. A brief discussion of International Financial Reporting Standards (IFRS) is included.

Accountants must first recognize a transaction, so cash accounting versus accrual accounting is presented. The accounting equation—Assets = Liabilities + Stockholders’ Equity—is introduced, and each element of the equation is defined. A variety of transactions are analyzed, and the effect of the transactions on the accounting equation is demonstrated. The financial statements—income statement, statement of retained earnings, balance sheet, and statement of cash flows—are introduced. The income statement, statement of retained earnings, and balance sheet are illustrated, and the interrelationship of these financial statements is emphasized.

**Learning Objectives**

*After studying Chapter 1, your students should be able to:*

1. Understand the nature of business and the role of accounting in business
2. Know how a business operates
3. Know the different types and forms of business
4. Know the key accounting principles and concepts
5. Know how accounting functions in a business
6. Understand and be able to prepare basic financial statements

**Teaching Outline**

**What Is a Business, and Why Study Accounting?**

1. **Understand the nature of business and the role of accounting in business (LO1)**
   1. **Accounting** is the process of recognizing, measuring, recording, and reporting information about a business’s transaction.
   2. **The Definition of a Business**
      1. An organization must have *three elements* to be called a business:
         1. Businesses are legal entities and must comply with applicable laws.
         2. A business must exchange a product (either a good or a service) for money or money substitutes. Simply providing a product is not sufficient; an exchange must take place.
            1. Goods

A good is a physical item that can be touched and felt.

Examples include food, cars, and clothing.

* + - * 1. Services

A service is an activity that exists but cannot be touched and felt.

Examples include medical services, car repairs, and education.

**Customer** is a person or organization that purchases a product from a business. This exchange is called a sale.

A **sale** is the exchange between a business and customer where the business provides a customer a product, and the business receives money or money substitutes.

* + - 1. Businesses create value. Customers get value from the benefits of a product or service; however, customers are not the only stakeholders that receive value. Other stakeholders include the owners of the business, lenders, and even employees.
  1. **The General Concept of Value**
     1. The **value** of an item is what someone is willing to pay for it. Value depends on:
        1. What the owner of an item expects to receive
        2. When the owner expects to receive it
        3. How certain the owner is about what he or she will receive and when it will be received
     2. A business wants to seek an exchange where the value received exceeds the value given up. Businesses buy or make products at one value (**cost**) and try to sell these products to their customers at a higher value (**revenue**). This exchange creates a **profit** (net benefit) to the business.
        1. **Cost** is the amount of money or money substitutes that a business pays to receive an item used in operating a business.
        2. **Revenue** is the amount of money or money substitutes that a business receives from the sale of a product.
        3. **Profit** is the revenue from a sale less the cost of the sale.
        4. **Risk** is the uncertainty that could result in an outcome not desired.
           1. Risk hurts value. As such, it is important for businesspeople to recognize, understand, measure, and manage risk.
           2. A **loss** is a negative profit that occurs when the cost of a sale is greater than the revenue from the sale. To minimize the possibility of a loss, accountants (who measure revenue, costs, and profits) use accounting information to help managers and other decision makers understand risk. Examples of how accounting information helps manage this risk are illustrated in every chapter, specifically Chapter 12, which covers financial statement analysis.
  2. **Business Owners and Other Stakeholders**
     1. A **stakeholder** is a person or an organization that is affected by a business.
        1. Examples include customers, employees, suppliers, regulators, society, lenders, and owners.
        2. Each stakeholder gives and receives value through an exchange and ideally believes that the value received exceeds the value given up.
  3. **The Goal of a Business**
     1. The goal of a business is to create value for its owners.
     2. To accomplish this goal, owners must appreciate that the other stakeholders must also receive value.

**How Does a Business Operate?**

1. **Know how a business operates (LO2)**
   1. To operate, businesses need to acquire money and use that money to make a profit. A firm acquires money by:
      1. Borrowing money from lenders (called liabilities)
         1. A **liability** is an amount owed to a lender or other creditor.
      2. Getting owners to put in their money (called **owners’** or **stockholders’ equity**) in exchange for a percentage of ownership
         1. **Stockholders’ equity** is money provided to the business by owners either through an initial investment or the retention of profits; also known as **owners’ equity**.
   2. **Operating the Business**
      1. To operate, a business acquires assets and hires people (employees). The business operates in hope of generating a profit where revenues are greater than expenses. Key terms for operating a business are defined:
         1. An **asset** is an economic resource that a business owns and can use to operate a business.
         2. **Employees** are people hired by a business for a period of time to operate the business.
         3. An **expense** is money or other value surrendered due to the sale of goods or services or the operating of the business.
         4. **Interest** is the expense of using borrowed money over a period of time.
         5. **Net income or loss** is the operating profit less interest expense, computed as revenue, less operating expenses, less interest expense.



* 1. **The Cost of Money**
     1. Creating value is more than just generating net income by selling a product.
     2. Money has a cost:
        1. Businesses have to pay interest if the money is borrowed.
        2. The money that an owner invests in a business also has a cost. Owners are not going to provide money without expecting a benefit or return over time. Otherwise, they could put their money in a bank and earn interest.
        3. The cost of money is dependent on many things, but above all else is a function of risk the owner or lender is taking. Great risk must be compensated by great return.

**How Are Businesses Organized?**

1. **Know the different types and forms of businesses (LO3)**
   1. Businesses are divided into two broad categories:
      1. A **for-profit business** is a business that attempts to create an exchange, or sale, where revenue exceeds expenses, creating a profit.
         1. Examples include Walmart, Ford, and Apple.
      2. A **not-for-profit business** is a business that attempts to create an exchange or sale where revenue equals costs.
         1. Examples include The Red Cross, Habitat for Humanity, religious organizations, and governments.
   2. Within the above categories are three typesof businesses:
      1. A **service business** is a business that sells a service to its customers.
         1. Examples include accounting and law firms, painting companies, physical therapy offices, and automotive repair shops.
      2. A **merchandising business** is a business that sells physical goods or products to its customers.
         1. A merchandising business may either be a wholesale business or a retail business.
            1. A **wholesale business** is a business that sells products to other businesses for resale.

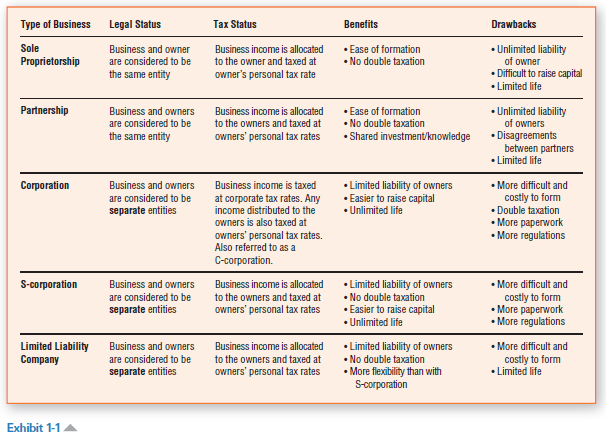
Example includes a business that sells food products to a grocery store.

* + - * 1. A **retail business** is a business that sells products to the final consumer of the product.

Examples include Target, Macy’s, and Kroger.

* + 1. A **manufacturing business** is a business that produces the physical goods that it sells to its customers.
       1. Examples include automobile manufacturers, makers of clothing, and soft drink manufacturers.
  1. There are several legal forms of businesses:
     1. A **sole proprietorship** is a business entity that has one owner, where, for legal and tax purposes, the business and the owner are considered the same.
        1. The business owner is personally responsible or liable for all of the debts and obligations of the business. Suing the business means suing the owner.
        2. All income or loss generated by the business is reported on the owner’s personal tax return and taxed at individual rates.

1. A **partnership** is a business that has more than one owner, where, for legal and tax purposes, the business and the owners are considered the same.
   * + 1. A partnerships is similar to sole proprietorship except that it has two or more owners.
       2. For legal purposes, owners and businesses are same. Suing the business means suing the business owners.
       3. For tax purposes, the partners divide all of the income or loss of the partnership and report it on their personal tax return (the same as with a sole proprietorship).
2. A **corporation** is a legal entity chartered under state law that is empowered to conduct business. The corporation and owners are considered as separate for legal and tax purposes.
   * + 1. Owners of a corporation and the corporation itself are separate under the law.
       2. Legal separation limits the personal liability of the owners to what they have invested in the corporation.
       3. A corporation is taxed separate from owners, using corporate tax rates.
       4. A **stockholder** is an owner of part of a corporation.
       5. A **dividend** is a payment of past and current profits, less losses, previously retained in the business.
3. Stockholders must pay a tax on the dividends they receive, resulting in double taxation.
4. An **S-corporation** is a small corporation that has met the legal requirement to act as a corporation but elected to be taxed at individual rates.
   * 1. A **limited liability company** is a hybrid business entity having characteristics of both a corporation and a partnership.
        1. It is a relatively new form of business and uses the letters LLC.
        2. Owners have the same legal separation as with a corporation.
        3. For tax purposes, an LLC’s income is treated similar to income in a sole proprietorship or partnership: Income is divided among owners and taxed at their personal rates.
        4. The method of distributing earnings among the owners is more flexible than with an S-corporation.
5. Exhibit 1-1 compares the forms of business.



**What Is Accounting, and What Are the Key Accounting Principles and Concepts?**

1. **Know the key accounting principles and concepts (LO4)**
   1. **Financial accounting** is the process of recognizing, measuring, recording, and reporting information about a business’s transactions to stakeholders outside the business, including stockholders (owners) and lenders.
   2. **Generally Accepted Accounting Principles (GAAP)** are the rules, principles, and concepts established by the accounting profession that govern financial accounting.
      1. The **Financial Accounting Standards Board (FASB)** is a seven-person group primarily responsible for the establishment of standards of financial accounting and reporting called GAAP.
      2. **International Financial Accounting Standards (IFRS)** are the accounting standards developed by the International Accounting Standards Board for use throughout the world.
         1. Originally followed by businesses located in countries that did not have their own accounting standards.
         2. Today, many countries that have their own accounting principles have started to allow the use of IFRS in addition to, or instead of, their own standards.
         3. The United States is currently considering adopting IFRS.
   3. The **business entity principle** dictates that the financial affairs of a business organization must be kept separate from the personal financial affairs of the business owners.
   4. The **reliability (objectivity) principle** requires information to be verifiable and confirmable by an independent observer. Also called the **objectivity principle**.
      1. Accounting information should be independently verifiable so that the outside user can rely on the correctness of the information reported.
      2. An example is a bank statement, which is an independent document that supports the checking account balance in the business’s accounting records.
   5. The **cost principle** states that when a business acquires assets or services, they should be recorded at their **actual cost**, also called **historical costs**.
   6. **Accounting Ethics**
      1. Accountants must be trustworthy and perform their accounting duties in accordance with high ethical standards.
      2. Accountants must provide clear and complete information, not manipulate the financial information so as to mislead stakeholders, and they must make their best efforts to prevent fraud.

**What Is the Role of Accounting in a Business?**

1. **Know how accounting functions in a business (LO5)**
   1. **How Do You Recognize a Business Transaction?**
      1. **Cash accounting** is a method of accounting that recognizes business transactions when cash is received or disbursed.
      2. **Accrual accounting** is a method of accounting that recognizes a business transaction when it occurs, whether or not cash is received or disbursed.
   2. **How Do You Measure a Business Transaction?**
      1. U.S. GAAP provides the guidelines for measuring transactions.
      2. Sometimes accountants have to make estimates.
      3. U.S. GAAP is conservative when determining how to record transactions.
   3. **How Do You Record Business Transactions Using the Accounting Equation?**
      1. The **fundamental accounting equation** is the equation that total assets equal the sum of total liabilities and total stockholders’ equity. Assets represents what the business owns, whereas liabilities and stockholders’ equity represents who provides the money.
      2. Assets = Liabilities + Stockholders’ Equity
         1. The accounts that affect stockholders’ equity.
            1. **Common stock** is the portion of the stockholders’ equity that is the result of the owners of the business investing money (or other assets) into the business.
            2. **Retained earnings** is the portion of the stockholders’ equity that is the result of the business having net income, or net earnings, that have been retained in the business. These are the subcategories and the information they reflect:

**Revenues** are used to reflect an increase in retained earnings that is the result of the business providing goods and services.

**Expenses** are used to reflect a decrease in retained earnings that is the result of the business incurring costs related to providing goods and services.

**Dividends** are used to reflect a decrease in retained earnings that is the result of the owners receiving assets (usually cash) from the business.

* + - 1. Other accounts are used in the business transactions illustrated in this chapter.
         1. **Prepaid expenses** are amounts that are assets of a business because they represent items that have been purchased but will be used later.
         2. **Accounts payable** represents a liability incurred by a business when purchasing goods and services.
         3. **Notes payable** is a liability that is represented by a written promise that requires future payment.
         4. **Accounts receivable** is an asset that represents amounts owed to the business by its customers.
         5. **On account** is buying or selling on credit.
  1. See textbook for illustrations on using the accounting equation. An expanded version of the accounting equation:



**How Do You Report Business Transactions Using Financial Statements?**

1. **Understand and be able to prepare basic financial statements (LO6)**
   1. **Financial statements** are historical, objective reports, prepared according to GAAP, that communicate financial information about a business.
      1. Four basic financial statements are prepared by most organizations, in this order:
         1. The **income statement** is a financial statement that reports the revenue and expenses of a business during a given period of time.
            1. Answers the question “Is the organization generating any net income?”
            2. Exhibit 1-2 illustrates the income statement for Quinn Accounting, Inc.
            3. The title should include the name of the business, the name of the financial statement, and the time period.

Time period for this statement is not a single date (for example, if reporting for the month of January, 2016, the title should state “Month Ended January 31, 2016” or “For the Month Ended January 31, 2016,” not just “January 31, 2016”).

* + - 1. The **statement of retained earnings** is a financial statement that reports the amount of accumulated net profits that a business has retained and not paid in dividends since inception. The statement reports the beginning balance of retained earnings, plus net income (or minus net loss) in the given period, less the dividends during the given period, equaling the ending retained earnings.
         1. Answers the question “How much net income has the corporation made and kept during current accounting period?”
         2. Exhibit 1-2 illustrates the statement of retained earnings for Quinn Accounting, Inc.
         3. Like the income statement, reports on a specific time period, such as a month or year.
      2. The **balance sheet** or **statement of financial position** is a financial statement that reports the assets, liabilities, and stockholders’ equity of a business at a specific point in time.
         1. Answers the question “What asset does the company have, and who has ownership rights to those assets?”
         2. Exhibit 1-2 illustrates the balance sheet for Quinn Accounting, Inc.
         3. Reports balances as of a specific day, not a time period (for example, “January 31, 2016”).
         4. The ending balance of retained earnings in the statement of retained earnings is used when preparing the balance sheet.
      3. **Statement of cash flows** is a financial statement that reports the sources and uses of cash for a given period of time.
         1. Answers the question “Where did the business get the money it needed to operate, and where did it spend its money?”
         2. Reported for three different types of business activities.

**Operating activities** are the activities that create revenue and/or expense in the entity’s major line of business.

**Investing activities** are decisions made by management to buy and sell long-term assets.

**Financial activities** are actions that generate the receipt or payment of cash to pay long-term liabilities or to raise capital.

* + - * 1. Exhibit 1-2 illustrates a statement of cash flows for Quinn Accounting, Inc.
        2. Like the income statement, reports on a specific time period, such as a month or year.
    1. These reports show the entity’s financial information to interested stakeholders both inside and outside the company

**Key Topics**

We study accounting because of what accounting reveals. ***Accounting*** is the process of recognizing, measuring, reporting, and reporting information about a business’s transactions. A ***business*** is defined as a legal organization that attempts to create value by exchanging products or services with customers for money. Businesses buy or make products at one value (cost) and try to sell these products at a higher value (revenue). This exchange creates a profit to the business.

In addition to the amount of profit, businesspeople also worry about when they make a profit and the risk they take to generate a profit. **Risk** is the uncertainty that an outcome we do not expect or desire could result. This could cause a business to incur a loss, where revenue is less than cost. Risk hurts value. Businesspeople must recognize, understand, and manage risk. To compensate for taking a risk, businesses expect higher profits. A business has many stakeholders (person or organization affected by the business). These stakeholders include customers, employees, suppliers, regulators, society, lenders, and owners. Each stakeholder believes that the value received from the business will exceed the value given up.

Resources are needed to start and operate a business. Businesses need to acquire money and to use that money to make a profit. A firm acquires money from two major sources: (1) Businesses borrow money from lenders (i.e., banks), creating liabilities, and/or (2.) businesses get the owners to put in their personal money in exchange for a percentage ownership. The owners’ contribution is called stockholders’ equity.

After starting a business, the next step is to operate the business. The business uses the money (borrowed from lenders and/or contributions from owners) to acquire assets and hire people. Employees use these assets to generate revenue for the business. Expenses are incurred in operating the business, and interest is paid on money borrowed. After these expenses and interest are paid out of the revenue received, the owners of the business get what remains, referred to as profit, or net income.

There are two categories of business: for-profit and not-for-profit. A for-profit business attempts to create a profit, whereas a not-for-profit business attempts to exceed or cover its costs. Within these categories are three types of businesses: service businesses, merchandising businesses, and manufacturing businesses. Businesses must also be legally formed into one of the following: sole proprietorship, partnership, corporation, S-corporation, or limited liability company. The legal status for the business determines who incurs liability, how taxes are paid, and other characteristics, such as the life of the company and what encompasses the business entity. Exhibit 1-1 summarizes these business organizations.

Corporate status is not based on the size of a company. Not all large companies are corporations, and not all small companies are sole proprietorships and partnerships. A corporation could have only one stockholder. Regardless of the number of stockholders, all corporations follow the same general corporate procedures.

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 a company on a day-to-day basis.

All companies, public and private, must follow Generally Accepted Accounting Principles(GAAP), which are written by the Financial Accounting Standards Board (FASB). Adhering to the same set of standards is critical for analyzing financial statements. But what about companies that are worldwide or solely located in other countries besides the United States? The International Accounting Standards Board developed the International Financial Reporting Standards (IFRS). Initially, the IFRS were used by businesses in countries with no official accounting guidelines. Today, many countries that have their own accounting principles have started to allow the use of IFRS in addition to or instead of their own standards. Since there is no date or certainty about when these U.S. standards will change, the focus of this book is current U.S. GAAP.

Chapter 1 describes core accounting principles that must be followed. The **business entity principle** dictates that the financial affairs of a business organization must be kept separate from the personal financial affairs of the business owners. The **reliability (objectivity) principle** states that information should be verifiable and confirmable by any independent observer. And the **cost principle** states that when a business acquires assets or services, they should be recorded at their actual (historical) cost. Ethics is also an important trait in recording financial transactions. Accountants should be trustworthy and perform their accounting duties in accordance with the highest ethical standards. They must provide clear and complete information, not manipulate the financial information so as to mislead stakeholders, and they must make their best efforts to prevent fraud.

If time permits, ask your students to read the **Accounting in Your World** on page 11. Students love to share their opinions, and ethics provides the instructor the opportunity to enforce the importance of “doing the right thing.”

Accountants must recognize a business transaction and know if/how to record it. There are two main accounting methods that determine how transactions are recognized. Under the **cash accounting** method, a business may choose to recognize business transactions only when cash is received or exchanged. Small businesses, which are not subject to regulatory reporting, might use this method. However, most businesses, in accordance with GAAP, use **accrual accounting**, which recognizes a business transaction when it occurs, regardless of whether cash is received or disbursed.

The next section of the chapter demonstrates how to record transactions using the accounting equation. Along with the transactions, definitions of the major account categories are provided. Students will be able to begin to record business transactions. An understanding of the accounting equation—Assets = Liabilities + Stockholders’ Equity—is essential. They will use this equation to record a series of accounting transactions. Many students learn through visual aids. As you discuss the transactions recorded using this equation, emphasize that the left side must equal the right side. Students are sometimes intimidated by the word *equation*, so illustrations that help them focus on having balanced amounts can help simplify the equation.

The last section covers the basic financial statements. Students need to understand the components of financial statements and their purpose. Be sure they know that there is an order to the preparation of the statements and that it must be followed in order to obtain the data for the next statements in sequence. Students also need to know which statements are for a time period versus a specific date.

Chapter 1 jumps right into the accounting equation. In order for students to be successful, it is critical to comprehend the first three chapters. These chapters cover the foundation of accounting, and subsequent chapters build on this foundation. Lectures for this chapter should include adequate time solving the accounting equation. Most students are visual learners, and working various types of transactions will help reinforce that this equation is solved the same way, regardless of the type of transaction. When a transaction involves cash, emphasize the cash side of the entry. Are they adding to their cash or taking away from cash? Working the cash side is logical for students. Once they think about whether cash is increasing or decreasing, the other side will work itself out. You can also emphasize that when one side increases, the other side must increase for the equation to stay in balance. If the transaction involves the same side of the equation, then one entry must increase and the other must decrease in order to stay in balance. Once the student understands the logical process, they will be less likely to try memorization, which is not a successful approach to working accounting problems.

Both the exercises and the problems for each chapter have a Group A and a Group B. These problems are identical except that the names, the dates, and the dollar amounts change. When assigning homework, you might want to work the alternate problem in class. For example, if you assign P1-31A “Transaction analysis and the calculation of net income,” you can work P1-36B in class. Working the B problem in class will provide a visual reference for the student that can be used as an aid for solving the remaining assignments.

**Chapter 1: Student Summary Handout**

**What Is a Business, and Why Study Accounting?**

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8. **Net income or loss** is the operating profit less interest expense, computed as revenue, less operating expenses, less interest expense.



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**How Are Businesses Organized?**

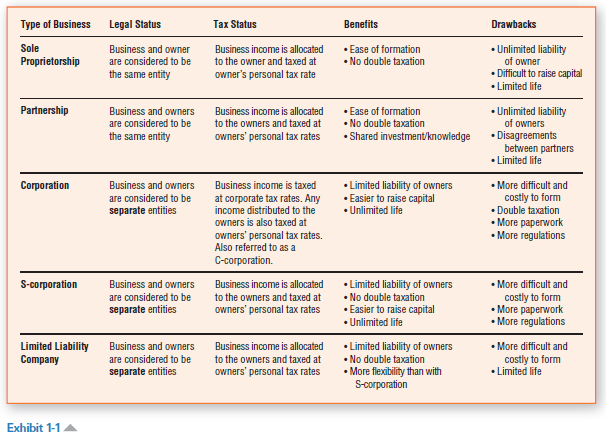
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6. A **service business** is a business that sells a service to its customers.
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   * + - 1. A **wholesale business** is a business that sells products to other businesses for resale.

Example includes a business that sells food products to a grocery store.

* + - * 1. A **retail business** is a business that sells products to the final consumer of the product.

Examples include Target, Macy’s, and Kroger.

1. A **manufacturing business** is a business that produces the physical goods that it sells to its customers.
2. Examples include automobile manufacturers, makers of clothing, and soft drink manufacturers.
   1. There are several legal forms of businesses:
3. A **sole proprietorship** is a business entity that has one owner, where, for legal and tax purposes, the business and the owner are considered the same.
4. The business owner is personally responsible or liable for all of the debts and obligations of the business. Suing the business means suing the owner.
5. All income or loss generated by the business is reported on the owner’s personal tax return and taxed at individual rates.
6. A **partnership** is a business that has more than one owner, where, for legal and tax purposes, the business and the owners are considered the same.
   * + 1. A partnerships is similar to sole proprietorship except that it has two or more owners.
       2. For legal purposes, owners and businesses are same. Suing the business means suing the business owners.
7. For tax purposes, the partners divide all of the income or loss of the partnership and report it on their personal tax return (the same as with a sole proprietorship).
8. A **corporation** is a legal entity chartered under state law that is empowered to conduct business. The corporation and owners are considered as separate for legal and tax purposes.
   * + 1. Owners of a corporation and the corporation itself are separate under the law.
       2. Legal separation limits the personal liability of the owners to what they have invested in the corporation.
       3. A corporation is taxed separate from owners, using corporate tax rates.
       4. A **stockholder** is an owner of part of a corporation.
       5. A **dividend** is a payment of past and current profits, less losses, previously retained in the business.
9. Stockholders must pay a tax on the dividends they receive, resulting in double taxation.
10. An **S-corporation** is a small corporation that has met the legal requirement to act as a corporation but elected to be taxed at individual rates.
11. A **limited liability company** is a hybrid business entity having characteristics of both a corporation and a partnership.
12. It is a relatively new form of business and uses the letters LLC.
13. Owners have the same legal separation as with a corporation.
14. For tax purposes, an LLC’s income is treated similar to income in a sole proprietorship or partnership: Income is divided among owners and taxed at their personal rates.
15. The method of distributing earnings among the owners is more flexible than with an S-corporation.
16. Exhibit 1-1 compares the forms of business.



**What Is Accounting, and What Are the Key Accounting Principles and Concepts?**

1. **Know the key accounting principles and concepts (LO4)**
   1. **Financial accounting** is the process of recognizing, measuring, recording, and reporting information about a business’s transactions to stakeholders outside the business, including stockholders (owners) and lenders.
   2. **Generally Accepted Accounting Principles (GAAP)** are the rules, principles, and concepts established by the accounting profession that govern financial accounting.
      1. The **Financial Accounting Standards Board (FASB)** is a seven-person group primarily responsible for the establishment of standards of financial accounting and reporting called GAAP.
      2. **International Financial Accounting Standards (IFRS)** are the accounting standards developed by the International Accounting Standards Board for use throughout the world.
         1. Originally followed by businesses located in countries that did not have their own accounting standards.
         2. Today, many countries that have their own accounting principles have started to allow the use of IFRS in addition to, or instead of, their own standards.
         3. The United States is currently considering adopting IFRS.
   3. The **business entity principle** dictates that the financial affairs of a business organization must be kept separate from the personal financial affairs of the business owners.
   4. The **reliability (objectivity) principle** requires information to be verifiable and confirmable by an independent observer. Also called the **objectivity principle**.
      1. Accounting information should be independently verifiable so that the outside user can rely on the correctness of the information reported.
      2. An example is a bank statement, which is an independent document that supports the checking account balance in the business’s accounting records.
   5. The **cost principle** states that when a business acquires assets or services, they should be recorded at their **actual cost**, also called **historical costs**.
   6. **Accounting Ethics**
      1. Accountants must be trustworthy and perform their accounting duties in accordance with high ethical standards.
      2. Accountants must provide clear and complete information, not manipulate the financial information so as to mislead stakeholders, and they must make their best efforts to prevent fraud.

**What Is the Role of Accounting in a Business?**

1. **Know how accounting functions in a business (LO5)**
   1. **How Do You Recognize a Business Transaction?**
      1. **Cash accounting** is a method of accounting that recognizes business transactions when cash is received or disbursed.
      2. **Accrual accounting** is a method of accounting that recognizes a business transaction when it occurs, whether or not cash is received or disbursed.
2. **How Do You Measure a Business Transaction?**
3. U.S. GAAP provides the guidelines for measuring transactions.
4. Sometimes accountants have to make estimates.
5. U.S. GAAP is conservative when determining how to record transactions.
6. **How Do You Record Business Transactions Using the Accounting Equation?**
7. The **fundamental accounting equation** is the equation that total assets equal the sum of total liabilities and total stockholders’ equity. Assets represents what the business owns, whereas liabilities and stockholders’ equity represents who provides the money.
8. Assets = Liabilities + Stockholders’ Equity
   * + 1. The accounts that affect stockholders’ equity.
          1. **Common stock** is the portion of the stockholders’ equity that is the result of the owners of the business investing money (or other assets) into the business.
          2. **Retained earnings** is the portion of the stockholders’ equity that is the result of the business having net income, or net earnings, that have been retained in the business. These are the subcategories and the information they reflect:

**Revenues** are used to reflect an increase in retained earnings that is the result of the business providing goods and services.

**Expenses** are used to reflect a decrease in retained earnings that is the result of the business incurring costs related to providing goods and services.

**Dividends** are used to reflect a decrease in retained earnings that is the result of the owners receiving assets (usually cash) from the business.

* + - 1. Other accounts are used in the business transactions illustrated in this chapter.
         1. **Prepaid expenses** are amounts that are assets of a business because they represent items that have been purchased but will be used later.
         2. **Accounts payable** represents a liability incurred by a business when purchasing goods and services.
         3. **Notes payable** is a liability that is represented by a written promise that requires future payment.
         4. **Accounts receivable** is an asset that represents amounts owed to the business by its customers.
         5. **On account** is buying or selling on credit.

1. See textbook for illustrations on using the accounting equation. An expanded version of the accounting equation:



**How Do You Report Business Transactions Using Financial Statements?**

1. **Understand** **and be able to prepare basic financial statements (LO6)**
2. **Financial statements** are historical, objective reports, prepared according to GAAP, that communicate financial information about a business.
3. Four basic financial statements are prepared by most organizations, in this order:
   * + 1. The **income statement** is a financial statement that reports the revenue and expenses of a business during a given period of time.
          1. Answers the question “Is the organization generating any net income?”
          2. Exhibit 1-2 illustrates the income statement for Quinn Accounting, Inc.
          3. The title should include the name of the business, the name of the financial statement, and the time period.

Time period for this statement is not a single date (for example, if reporting for the month of January, 2016, the title should state “Month Ended January 31, 2016” or “For the Month Ended January 31, 2016,” not just “January 31, 2016”).

* + - 1. The **statement of retained earnings** is a financial statement that reports the amount of accumulated net profits that a business has retained and not paid in dividends since inception. The statement reports the beginning balance of retained earnings, plus net income (or minus net loss) in the given period, less the dividends during the given period, equaling the ending retained earnings.
         1. Answers the question “How much net income has the corporation made and kept during current accounting period?”
         2. Exhibit 1-2 illustrates the statement of retained earnings for Quinn Accounting, Inc.
         3. Like the income statement, reports on a specific time period, such as a month or year.
      2. The **balance sheet** or **statement of financial position** is a financial statement that reports the assets, liabilities, and stockholders’ equity of a business at a specific point in time.
         1. Answers the question “What asset does the company have, and who has ownership rights to those assets?”
         2. Exhibit 1-2 illustrates the balance sheet for Quinn Accounting, Inc.
         3. Reports balances as of a specific day, not a time period (for example, “January 31, 2016”).
         4. The ending balance of retained earnings in the statement of retained earnings is used when preparing the balance sheet.
      3. **Statement of cash flows** is a financial statement that reports the sources and uses of cash for a given period of time.
         1. Answers the question “Where did the business get the money it needed to operate, and where did it spend its money?”
         2. Reported for three different types of business activities.

**Operating activities** are the activities that create revenue and/or expense in the entity’s major line of business.

**Investing activities** are decisions made by management to buy and sell long-term assets.

**Financial activities** are actions that generate the receipt or payment of cash to pay long-term liabilities or to raise capital.

* + - * 1. Exhibit 1-2 illustrates a statement of cash flows for Quinn Accounting, Inc.
        2. Like the income statement, reports on a specific time period, such as a month or year.

1. These reports show the entity’s financial information to interested stakeholders both inside and outside the company

# Assignment Grid

**Estimated Level**

**Learning Time in of**

**Assignment Topic(s) Objective(s) Minutes Difficulty**

***Short Exercises***

S1-1 Accounting principles 4 5-10 Easy

S1-2Accounting principles 4 5-10 Easy

S1-3 Accounting terminology 2, 3 10-15 Easy

S1-4 Basic accounting equation 5 5-10 Easy

S1-5 Basic accounting equation 5 5-10 Easy

S1-6 Basic accounting equation 5 5-10 Easy

S1-7 Basic accounting equation 5 5-10 Easy

S1-8 Entering transactions in the accounting equation 5 5-10 Easy

S1-9 Basic accounting equation 5 5-10 Easy

S1-10 Basic financial statements 6 5-10 Easy

S1-11 Entering transactions in the accounting equation 5 5-10 Easy

S1-12 Transaction analysis 5 5-10 Easy

S1-13 Transaction analysis 5 5-10 Easy

S1-14 Transaction analysis and

calculating net income 5 5-10 Easy

***Exercises (Group A)***

E1-15A Basic accounting equation 5 10-15 Easy

E1-16A Basic accounting equation 5 10-15 Easy

E1-17A Basic accounting equation 5 10-15 Easy

E1-18A Using the accounting equation to determine

net income 5, 6 15-20 Medium

E1-19A Transaction analysis 5 15-20 Medium

E1-20A Types of business organizations and

balance sheet preparation 3, 6 10-15 Medium

E1-21A Types of accounts and income

statement preparation 5, 6 15-20 Medium

E1-22A Using the accounting equation to

determine net income 5, 6 15-20 Medium

***Exercises (Group B)***

E1-23B Basic accounting equation 5 10-15 Easy

E1-24B Basic accounting equation 5 10-15 Easy

E1-25B Basic accounting equation 5 10-15 Easy

E1-26B Using the accounting equation to determine

net income 5, 6 15-20 Medium

E1-27B Transaction analysis 5 15-20 Medium

E1-28B Types of business organizations and

balance sheet preparation 5, 6 10-15 Medium

E1-29B Types of accounts and income

statement preparation 5, 6 15-20 Medium

E1-30B Using the accounting equation to

determine net income 5, 6 15-20 Medium

**Estimated Level**

**Learning Time in of**

**Assignment Topic(s) Objective(s) Minutes Difficulty**

***Exercises (Alternatives 1, 2, and 3)***

Available at [www.myaccountinglab.com](http://www.myaccountinglab.com)

***Problems (Group A)***

P1-31A Transaction analysis and calculation of

net income 5 20-25 Medium

P1-32A Income statement and balance sheet

transactions; prepare the income statement

and balance sheet 5, 6 25-30 Difficult

P1-33A Prepare the income statement, statement of

retained earnings, and balance sheet 6 20-25 Medium

P1-34A Prepare the income statement and balance sheet;

identify certain financial information 6 25-30 Medium

P1-35A Error analysis and preparation of balance

sheet 6 20-25 Difficult

***Problems (Group B)***

P1-36B Transaction analysis and calculation of

net income 5 20-25 Medium

P1-37B Income statement and balance sheet

transactions; prepare the income statement

and balance sheet 5, 6 25-30 Difficult

P1-38B Prepare the income statement, statement of

retained earnings, and balance sheet 6 20-25 Medium

P1-39B Prepare the income statement and balance sheet;

identify certain financial information 6 25-30 Medium

P1-40B Error analysis and preparation of balance

sheet 6 20-25 Difficult

***Problems (Alternatives 1, 2, and 3)***

Available at [www.myaccountinglab.com](http://www.myaccountinglab.com)

***Continuing Exercise***

First exercise in a sequence

that begins an accounting cycle 5 25 Medium

***Continuing Problem***

First exercise in a sequence

that begins an accounting cycle 5, 6 60-75 Medium

***Continuing Financial Statement Analysis Problem***

First exercise in a sequence on

financial analysis 6 30 Medium

***\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_***

***Apply Your Knowledge***

Ethics in Action (2 cases) 4 30-60 Medium

***Know Your Business***

Financial Analysis 5, 660 Medium

Industry Analysis 5, 6 60 Medium

Small Business Analysis 5, 630 Medium

Written Communication 3 30 Medium

#### Assignments Available in Varied Accounting Software Formats:

Excel Templates: E1-18A, P1-33A

# Answer Key to Chapter 1 Quiz (on following pages)

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

Name Date Section

**CHAPTER 1**

**TEN-MINUTE QUIZ**

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

1. Which of the following statements is FALSE?
2. The sole proprietorship form of business organization protects the personal assets of the owners from creditors of the business.
3. A proprietorship has a single owner.
4. Accounting is the information system that measures business activities, processes that information into reports, and communicates the results to decision makers.
5. The FASB determines how accounting is practiced in the United States.
6. Financial accounting is the process of:
7. presenting information in an ethical manner.
8. providing information useful to managers in making daily decisions.
9. measuring and communicating information to the federal government.
10. recognizing, measuring, recording and reporting information about a business’s transaction.

3. Wilbur Corp. operates a fishing tackle shop. The company needs to borrow money to expand; therefore, it prepared financial statements to present to the banker. Wilbur Corp. obtained appraisals of all the assets of the business to ensure that the balance sheet would reflect the most current value of the assets. Wilbur Corp. has violated which of the following principles or concepts?

A. Reliability principle

B. Cost principle

C. Going-concern principle

D. Business entity principle

4. Which of the following statements is FALSE?

1. Assets are economic resources that are expected to benefit future periods.

B. Expenses are decreases in stockholders’ equity that result from delivering goods and services to customers.

C. Revenues are assets that represent economic benefits.

D. Liabilities are economic obligations to outsiders.

5. A payment on account:

1. decreases assets.
2. increases liabilities.
3. increases stockholders’ equity.
4. increases assets.

6. Which of the following transactions increases stockholders’ equity?

1. Collection of an account receivable
2. Issuance of common stock for cash
3. Payment of salaries
4. Cash purchase of land

7. A balance sheet reports the:

1. assets, liabilities, and stockholders’ equity on a particular date.
2. difference between revenues and expenses during the period.
3. change in the retained earnings during the period.
4. cash receipts and cash payments during the period.

8. If assets increase $40,000 during the period and liabilities decrease $8,000 during the period, stockholders’ equity must have:

1. increased $32,000.
2. decreased $48,000.
3. decreased $32,000.
4. increased $48,000.

9. The following information about the assets and liabilities applies at the end of 2016 and 2017:

2016 2017

**Assets** $75,000 $90,000

**Liabilities** 36,000 45,000

If net income was $1,500 and there were no dividends, how much did equity increase from new stock issuances?

1. $40,500
2. $45,000
3. $ 6,000
4. $ 4,500

10. In what order should the financial statements be prepared?

1. Income statement, cash flow statement, balance sheet, statement of retained earnings
2. Balance sheet, statement of retained earnings, income statement, statement of cash flow
3. Income statement, statement of retained earnings, balance sheet, statement of cash flows
4. Statement of cash flows, income statement, balance sheet, statement of retained earnings