

# Welcome to Accounting: Introduction and Financial Statements



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## Chapter Preview

Why is this class important? Why does a personal chef need to know accounting information? What career opportunities exist in accounting? When my business applies for a loan, how do I answer the bank's questions about financial statements? In this chapter, you will learn the answers to these questions.

### LEARNING OBJECTIVES

### PRACTICE

<p><b>LO 1</b> Identify the activities and users associated with accounting.</p>	<ul style="list-style-type: none"> <li>• Why Study Accounting?</li> <li>• Who Uses Accounting Information?</li> </ul>	<p><b>DO IT! 1a</b> Overview of Accounting</p> <p><b>DO IT! 1b</b> Internal and External Users</p>	<p><b>1</b> Review and Practice</p>
<p><b>LO 2</b> Identify the types of businesses associated with accounting.</p>	<ul style="list-style-type: none"> <li>• Types of Businesses That Use Accounting</li> <li>• Business Classifications</li> </ul>	<p><b>DO IT! 2a</b> Types of Businesses</p> <p><b>DO IT! 2b</b> Business Classifications</p>	<p><b>2</b> Review and Practice</p>
<p><b>LO 3</b> Explain the building blocks of accounting: ethics, principles, and assumptions.</p>	<ul style="list-style-type: none"> <li>• Ethics in Financial Reporting</li> <li>• Accounting Standards</li> <li>• Principles and Assumptions</li> </ul>	<p><b>DO IT! 3a</b> Role of Ethics</p> <p><b>DO IT! 3b</b> Accounting Standards</p> <p><b>DO IT! 3c</b> Principles and Assumptions</p>	<p><b>3</b> Review and Practice</p>
<p><b>LO 4</b> Prepare the four financial statements.</p>	<ul style="list-style-type: none"> <li>• Income Statement</li> <li>• Owner's Equity Statement</li> <li>• Balance Sheet</li> <li>• Statement of Cash Flows</li> <li>• Financial Statement Connections</li> </ul>	<p><b>DO IT! 4a</b> Net Income (Loss)</p> <p><b>DO IT! 4b</b> Assets, Liabilities, and Owner's Equity</p> <p><b>DO IT! 4c</b> Cash Flows</p> <p><b>DO IT! 4d</b> Financial Statement Items</p>	<p><b>4</b> Review and Practice</p>
<p><b>LO 5</b> Name career opportunities in accounting.</p>	<ul style="list-style-type: none"> <li>• Public Accounting</li> <li>• Private Accounting</li> <li>• Governmental Accounting</li> <li>• Forensic Accounting</li> </ul>	<p><b>DO IT! 5</b> Public Accounting and Accounting Careers</p>	<p><b>5</b> Review and Practice</p>

# The Importance of Accounting

**LO 1** Identify the activities and users associated with accounting.

## Why Study Accounting?

Welcome to accounting! Let's open the door to a learning adventure that will be instrumental to the success of your career. By the end of this journey, you will find how essential accounting is to all businesses, small and large. You will be able to understand accounting, the language of business (see **FYI**).



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### FYI

What you are about to study has been around since the days of Christopher Columbus! The origins of accounting are generally attributed to the work of Luca Pacioli (1447–1517), an Italian Renaissance mathematician. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

## Accounting: The Language of Business

What do a personal chef, a manager at a bed-and-breakfast inn, and the Nike chief financial officer all have in common? They need to know and understand accounting:

- Accounting reports, called financial statements, provide the information necessary to make the right decisions.
- As Harold Geneen, CEO of ITT Corporation, noted: “To be good at your business, you have to know the numbers—cold.”

So what do we mean by the numbers? **Accounting** is the information system that **identifies, records, and communicates** the economic events (the numbers) of an organization to interested users.

### EXAMPLE

To help you learn accounting, we review the business activities of Designer Dinners, a personal chef service, throughout this text. Dan Johnson, the owner of Designer Dinners, believes that business professionals and families often need help in food service preparation. Dan's business works as follows. Customers purchase the necessary food, and then Dan prepares meals in their homes. Dan does not have any employees, but he does hire cooking assistants for specific jobs when needed.

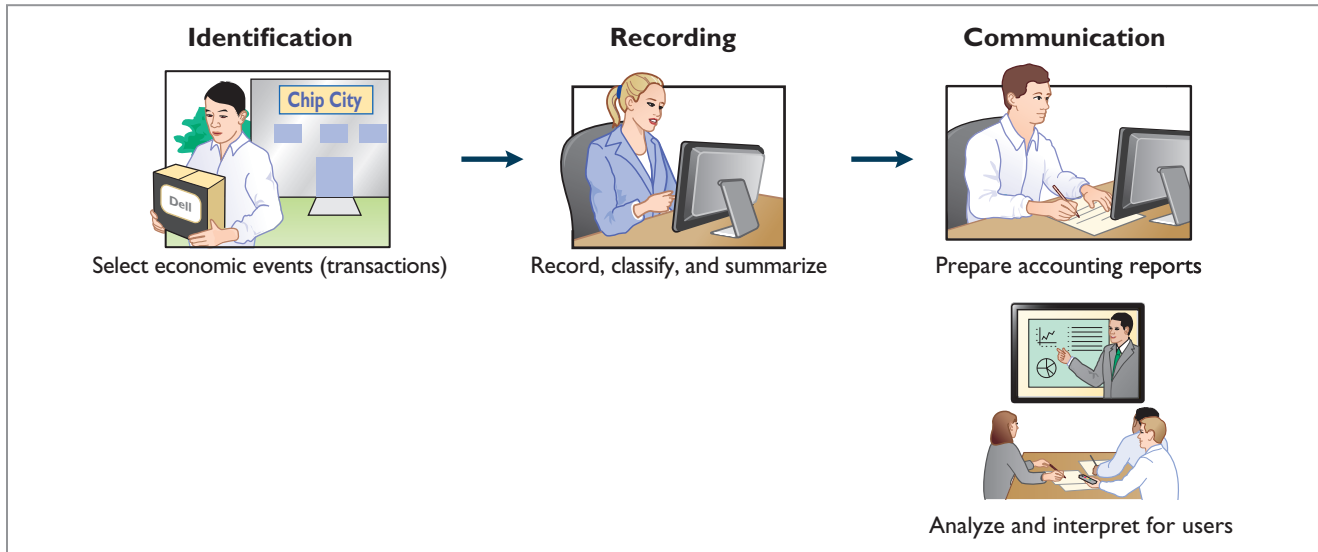
Let's take a closer look at the three activities of an accounting information system as shown in **Illustration 1.1**.

## Identify

As a starting point to the accounting process, a company identifies the economic events relevant to its business.

### EXAMPLE

Economic events for Designer Dinners include the purchase of cooking supplies, the use of cell phone service by Dan Johnson, the preparation of meals, and the receipt of payment from Dan's customers.

**ILLUSTRATION 1.1** The three activities of an accounting information system

## Record

Recording consists of keeping a systematic, chronological diary of economic events measured in dollars and cents.

### EXAMPLE

Designer Dinners records all economic events in order to provide a history of its financial activities. In recording, Designer Dinners also classifies and summarizes these economic events.

## Communicate

Companies communicate the collected information to interested users through the preparation of financial statements.

- Often, we refer to the communication process as **financial reporting**.
- A vital element in communicating economic events is the ability of the accountant to *analyze* as well as *interpret* and *explain* the financial information.

### EXAMPLE

Designer Dinners communicates the economic events it identifies and records by preparing financial statements.

## Bookkeeping

You may hear the term **bookkeeping** in a discussion of accounting:

- Bookkeeping involves only *recording* activities, whereas accounting includes *all three* activities.
- Recording activities involves setting up and maintaining accounting records.
- The difference between a bookkeeper and an accountant is the ability to identify and communicate accounting results. An accountant must be able to analyze and interpret financial information. A bookkeeper simply records the information.

## DO IT! 1a | Overview of Accounting

Indicate whether each of the three statements presented below is true or false. If false, explain why.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.

### Solution

1. True.
2. False. Bookkeeping involves only the recording step.
3. False. Accountants prepare, analyze, and interpret information in financial reports as part of the communication step.

## Who Uses Accounting Information?

The accounting information users need depends on the kinds of decisions they make. There are two broad groups of users of financial information—internal users and external users.

### Internal Users





**Internal users** of accounting information are managers who plan, organize, and run the business.

- Internal users include marketing managers, production supervisors, finance directors, and company officers.
- Internal users must answer many important questions, as shown in **Illustration 1.2**.

#### ILLUSTRATION 1.2

#### Internal user questions

### Questions Asked by Internal Users

 <p><b>Finance</b></p> <p>Do we have enough money to pay our bills?</p>	 <p><b>Marketing</b></p> <p>What price should we charge for our new product to make the most money?</p>	 <p><b>Human Resources</b></p> <p>Can we keep our employees happy by giving them raises?</p>	 <p><b>Management</b></p> <p>Which product line makes us the most money? Should we eliminate any product lines?</p>
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To answer the questions raised in Illustration 1.2, internal users such as Dan Johnson, the owner of Designer Dinners, need detailed accounting information on a timely basis.

- Such detailed accounting information may help Dan Johnson compare operating alternatives, project revenues and costs, and forecast cash needs.
- **Managerial accounting** is the field of accounting that provides internal users with the information they need to make effective decisions about their companies (see **FYI**).

### FYI

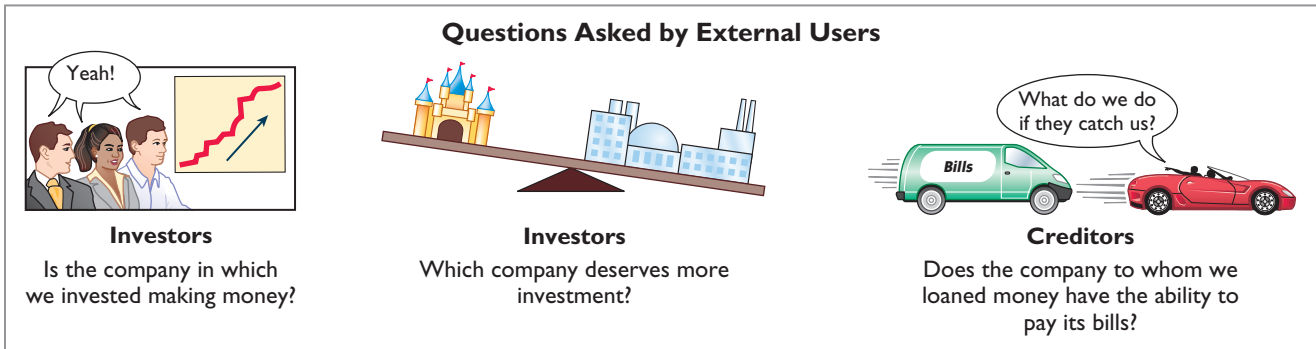
Think about your current job. Are you responsible for any planning or organizing at your company? If yes, then you need accounting information. The more accurate and timely accounting information you have, the better decisions you can make. That's why accounting will be important to you!

## External Users

**External users** are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.

1. **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership interests of a company.
2. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. **Illustration 1.3** shows questions that investors and creditors may ask.

**ILLUSTRATION 1.3** External user questions



To answer the questions raised in Illustration 1.3, external users need financial statements. You will learn about financial statements later in this chapter.

- **Financial accounting** is the field of accounting that provides economic and financial information for investors, creditors, and other external users (see **FYI**).

### FYI

Have you ever taken out a loan? If yes, the bank probably requested information about your income and credit history. Companies provide their financial statements when they need to borrow money from a creditor, such as a bank.

## Accounting in Various Fields of Business

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually *every field of business*. Consider these examples:

- **General management:** Managers at Ford Motors, Massachusetts General Hospital, California State University—Fullerton, a McDonald’s franchise, and a Trek bike shop all need to understand accounting data in order to make effective business decisions.
- **Marketing:** Marketing specialists at Procter & Gamble must be sensitive to costs and revenues, which are measured in accounting numbers. Making a sale to or performing a service for a customer is meaningless unless it is profitable.
- **Finance:** Do you want to be a banker for Citicorp, an investment analyst for Goldman Sachs, or a stockbroker for Merrill Lynch? These fields rely heavily on accounting knowledge to analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.
- **Real estate:** Are you interested in being a real estate broker for Prudential Real Estate? Because a third party—the bank—is almost always involved in financing a real-estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?
- **Your own company:** If you are interested in starting your own business, you may hire an accountant to help you. However, you still need to have a solid understanding of the accounting records of your company. Understanding the numbers will help you make better decisions.

**DO IT! 1b | Internal and External Users**

Indicate whether each of the three statements presented below is true or false. If false, explain why.

1. The two most common types of external users are investors and customers.
2. Managerial accounting activities focus on reports for internal users.
3. Financial statements provide information to external users.

**Solution**

1. False. The two most common types of external users are investors and creditors.
2. True.
3. True.

**LO 1 Review and Practice**

Identify the activities and users associated with accounting.

**Summary**

- Accounting is the language of business.
- In business, accounting and financial statements are the means for communicating the numbers.
- Accounting is the information system that identifies, records, and communicates the economic events of an organization to interested users.
- The major users of accounting information are internal and external users.
- Internal users of accounting information are managers who plan, organize, and run the business.
- External users are individuals and organizations outside a company who want financial information about the company.

**Key Terms**

**Accounting** The information system that identifies, records, and communicates the economic events of an organization to interested users.

**Bookkeeping** A part of the accounting process that involves only the recording of economic events.

**Financial accounting** The field of accounting that provides economic and financial information for investors, creditors, and other external users.

**Managerial accounting** The field of accounting that provides internal reports to help users make decisions about their companies.

**PRACTICE 1**

*Identify accounting activities and users.*

1. Which of the following is **not** a step in the accounting process?
  - a. Identification.
  - b. Simulation.
  - c. Recording.
  - d. Communication.
2. Accounting and bookkeeping are the same. Do you agree?
3. Examples of internal users of accounting information do **not** include:
  - a. marketing managers.
  - b. finance directors.
  - c. company officers.
  - d. creditors.
4. Examples of external users of accounting information do **not** include:
  - a. company officers.
  - b. investors.
  - c. bankers.
  - d. suppliers.

**Solution**

1. **b.** Simulation is not a step in the accounting process. Choices (a) identification, (c) recording, and (d) communication, are the three steps in the accounting process.
2. No. Bookkeeping usually involves only the recording of economic events and therefore is just one part of the entire accounting process. Accounting, on the other hand, involves the entire process of identifying, recording, and communicating economic events.

3. **d.** Creditors are not internal users. Creditors (such as suppliers and bankers) are external to the company and use accounting information to evaluate the risks of granting credit or lending money. Choices (a), (b), and (c) are all examples of internal users.
4. **a.** Company officers are not external users. Company officers are internal to a company. Choices (b), (c), and (d) are all examples of external users.


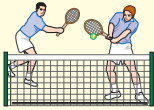

## Business Types and Classifications

**LO 2** Identify the types of businesses associated with accounting.

### Types of Businesses That Use Accounting

Accounting is used by all types of companies, big and small. As shown in **Illustration 1.4**, there are generally three types of businesses (see **FYI**).

**ILLUSTRATION 1.4** Three types of businesses

Characteristic	Proprietorship	Partnership	Corporation
<b>Number of owners</b>	1 	2 or more 	1 to thousands 
<b>Owner(s) role</b>	Owner is the manager/operator.	Duties of each partner vary.	Ownership is divided into transferable shares of stock.
<b>Features</b>	Only a relatively small amount of money (capital) is necessary. Tax advantages.	A partnership agreement sets forth initial investment and withdrawal procedures. Tax advantages.	Stockholders may transfer their ownership shares to other investors at any time (i.e., sell their shares). Enjoys an unlimited life. Tax disadvantage: double-taxed.
<b>Rights and responsibilities of owner(s)</b>	Owner (proprietor) receives any profits, suffers any losses, and is personally liable for all company debts.	Each partner shares in profits or losses and generally has unlimited personal liability for any company debts.	Holders of the shares (stockholders) enjoy limited liability; they are not personally liable for any company debts.
<b>Legal distinction</b>	There is no legal distinction between the business as an economic unit and the owner. Owner transactions must be separate from business.	A partnership agreement sets forth duties and division of net income (or net loss), and settlement. Owner transactions must be separate from business.	Corporations are organized as separate legal entities under state corporation law. Owner transactions must be separate from business.
<b>Examples</b>	Small service-type businesses, farms, and small retail stores.	Retail and service-type businesses, including professional practices (lawyers, doctors, architects, and CPAs).	Most of the largest companies in the United States—ExxonMobil, Ford, WalMart Stores, Inc., Citigroup, and Apple.

1. A business owned by one person is generally a **proprietorship** (also known as a sole proprietorship).

2. A business owned by two or more people associated as partners is a **partnership**.
3. A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is a **corporation**.

**FYI**

Note that although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the amount earned by corporations is eight times greater.

**EXAMPLE**

Because Dan Johnson is the only owner of Designer Dinners, he forms his company as a proprietorship. The proprietorship form makes sense for Dan since only a small amount of money is necessary to start the business. However, as shown in **Illustration 1.5**, Dan can grow his company from its current business form (as a proprietorship) to a partnership and then a corporation (see **Q & A**).

**ILLUSTRATION 1.5**  
How a company can evolve

Business Feature	Proprietorship	Partnership	Corporation
Company name	Designer Dinners	Designer Weddings	Designer Events, Inc.
Description	Dan Johnson operates his meal-preparation business as a proprietorship. Designer Dinners has only one owner, Dan, and he invests only a small amount of money (capital) to start this business.	Dan Johnson has a college friend Chris who is a florist. Their skills would combine well for wedding planning services. Dan creates a partnership, so that now he and Chris are co-owners of the company. Chris will invest some money to help the company move in this new direction.	As the business grows and becomes very successful doing corporate events all over the nation, Dan Johnson decides to incorporate. Dan and Chris will be the first to buy stock. The corporation can then offer stock to outside investors, allowing for further growth.

**Q & A**

**Q:** Are there other forms of business?

**A:** Yes. An LLC (limited liability company) has the advantage of limited liability, like a corporation, but an LLC may choose to pay income tax as a proprietorship, partnership, or corporation. This allows for tax advantages over a corporation, which is double-taxed.

PC stands for Professional Corporation. Alternatively, it can be called a Professional Service Corporation, abbreviated PSC. This form of business is similar to an LLC with the advantage of limited liability but is restricted to certain licensed professionals, such as accountants, lawyers, physicians, architects, and engineers.

**DO IT! 2a | Types of Businesses**

Indicate whether each of the three statements presented below is true or false. If false, explain why.

1. A business owned by one person generally is a proprietorship.
2. In most respects, a partnership is like a proprietorship except that more than one owner is involved.
3. Most of the largest companies in the United States are proprietorships.

**Solution**

1. True.
2. True.
3. False. Most of the largest companies in the United States are corporations. However, there are more partnerships and proprietorships in the United States than corporations.

## Business Classifications

All types of businesses use accounting information. For example, Designer Dinners is a service company because it performs a service (preparing meals for customers). Here are the major classifications (see **Illustration 1.6**).

### 1. Service company.

- As indicated, a **service company** performs a service for customers.
- Examples include professionals such as doctors, attorneys, and accountants; auto repair shops (Jiffy Lube); landscaping companies; spas (Red Door Spa); gyms (Gold's Gym); and personal chef services (Designer Dinners).

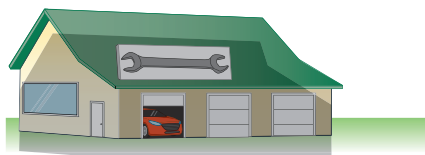
### 2. Retail (or merchandise) company.

- A **retail (merchandise) company** purchases and sells merchandise directly to consumers.
- Examples include Target, Nordstrom, Abercrombie & Fitch, and The Home Depot.

### 3. Manufacturing company.

- A **manufacturing company** converts raw materials into finished goods to sell to customers.
- Examples include The Hershey Company, Ford Motor Company, John Deere, and Intel.

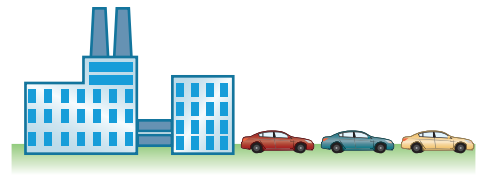
**ILLUSTRATION 1.6** Business classifications



**Service Company**  
(auto repair shop)



**Retail Company**  
(sporting goods store)



**Manufacturing Company**  
(automaker)

## DO IT! 2b | Business Classifications

Indicate whether each of the three statements presented below is true or false. If false, explain why.

1. WalMart is a service business.
2. A manufacturing company uses raw materials to produce finished goods to sell to customers.
3. General Motors is a retail company.

**Solution**

1. False. WalMart is a retail company.
2. True.
3. False. General Motors is a manufacturing company.

## LO 2 Review and Practice

Identify the types of businesses associated with accounting.

### Summary

- There are three types of business entities: proprietorship, partnership, and corporation.
  1. A proprietorship is a business owned by one person.
  2. A partnership is a business owned by two or more people.
  3. A corporation is a business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock.
- Businesses can be classified based on the operations of the business: service, retail (merchandising), and manufacturing companies.
  - A service company performs a service for customers.
  - A retail, or merchandising, company sells products to customers in the form in which the company purchased them.
  - A manufacturing company converts raw materials into finished goods to sell to customers.

### Key Terms

**Corporation** A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock.

**Manufacturing company** A business that converts raw materials into finished goods to sell to customers.

**Partnership** A business owned by two or more persons associated as partners.

**Proprietorship** A business owned by one person.

**Retail (merchandise) company** A business that sells products to customers in the form in which they were purchased.

**Service company** A business that performs a service for customers.

### PRACTICE 2

*Identify business types and classifications.*

1. The three types of businesses are:
  - a. Proprietorships, small businesses, and partnerships.
  - b. Proprietorships, partnerships, and corporations.
  - c. Proprietorships, partnerships, and large businesses.
  - d. Small businesses, medium businesses, and large businesses.
2. A small grass-cutting company owned by an individual is most likely to be organized as a:
  - a. proprietorship.
  - b. partnership
  - c. corporation.
  - d. joint venture.
3. An example of a service company does **not** include a(n):
  - a. auto repair shop.
  - b. doctor's office.
  - c. landscaping company.
  - d. grocery store.

### Solutions

1. **b.** Proprietorships, partnerships, and corporations are the three types of businesses. Choices (a), (c), and (d) are incorrect because small, medium, and large businesses only denote the sizes of businesses.
2. **a.** A small grass-cutting company with one owner would most likely be organized as a proprietorship. The other choices are incorrect because (b) a partnership has more than one owner; (c) a corporation is organized as a separate legal entity under state corporation law, having ownership divided into shares of stock; and (d) a joint venture involves two or more parties.
3. **d.** A grocery store is a retail (merchandising) company. Choices (a), (b), and (c) are examples of service companies.

# The Building Blocks of Accounting

**LO 3** Explain the building blocks of accounting: ethics, principles, and assumptions.

Just as your doctor follows certain protocols in treating your illnesses, *companies must follow certain standards* to identify, record, and communicate their financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be present—ethical behavior.

## Ethics in Financial Reporting

**Ethics** are the standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.


- Effective financial reporting depends on sound ethical behavior.
- Creditors and investors will make funds available only if they trust the financial information provided by owners.

### EXAMPLE

Designer Dinners needs a loan from the local bank to purchase additional cooking equipment. The bank will require credible financial information in order to determine if Designer Dinners qualifies for a loan. If Dan does not provide accurate information, the bank might lose money. Imagine if a large corporation such as PepsiCo provided inaccurate information. What impact would that have on the economy?

You will be faced with ethical dilemmas involving your friends, your work, or other situations that arise in your life. **Illustration 1.7** provides a framework that you might use to resolve any ethical dilemmas you might face.

### ILLUSTRATION 1.7 Steps in analyzing ethics cases and situations

	<p><b>1. Recognize an ethical situation and the ethical issues involved.</b> Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.</p>	<p><b>2. Identify and analyze the principal elements in the situation.</b> Identify the <b>stakeholders</b>—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?</p>	<p><b>3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.</b> Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.</p>
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## Sarbanes-Oxley Act

In past years, the media was full of articles about financial scandals at Enron, WorldCom, HealthSouth, AIG, and other companies. As the scandals came to light, mistrust of financial reporting in general grew. United States regulators and lawmakers were concerned that if investors lost confidence in corporate accounting because of unethical financial reporting, the economy would suffer.

- In response, Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals.
- As a result of SOX, top management must now certify the accuracy of financial information.

- In addition, penalties for fraudulent financial activity are much more severe.
- Also, SOX increased the independence requirements of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors.

### DO IT! 3a | The Role of Ethics

Indicate whether each of the three statements presented below is true or false. If false, explain why.

1. Effective financial reporting depends on sound ethical behavior.
2. Congress passed the Sarbanes-Oxley Act to reduce unethical behavior and decrease the likelihood of future corporate scandals.
3. As a result of the Sarbanes-Oxley Act, penalties for fraudulent financial activity are much less severe.

#### Solution

1. True.
2. True.
3. False. The Sarbanes-Oxley Act made penalties much more severe if companies are involved in fraudulent financial activity.

## Accounting Standards

As indicated earlier, companies must follow certain standards in preparing financial statements. Let's learn about this *common set of standards*.

### Generally Accepted Accounting Principles (GAAP)

The accounting profession has developed standards that are generally accepted and practiced in the United States.

- This common set of standards, called **generally accepted accounting principles (GAAP)**, indicates how to report economic events.
- Simply put, these are the accounting rules.

### Standard-Setting Bodies

Within the United States, the accounting profession relies on two main standard-setting bodies:

1. The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The FASB is a private organization (not a government entity) that makes the U.S. accounting rules, or GAAP.
2. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC enforces the U.S. accounting rules, or GAAP.
  - The SEC relies on the FASB to develop accounting standards, which public companies must follow.
  - A public company is one whose stock is traded on a national stock exchange. You are probably familiar with public companies such as PepsiCo and Facebook.

You will want to know and understand the abbreviations we have just presented that refer to the accounting standards and standard-setting bodies. **Illustration 1.8** provides a quick reminder.

Abbreviation	Meaning	Quick Description
GAAP	Generally accepted accounting principles	The U.S. accounting rules
FASB	Financial Accounting Standards Board	Makes the U.S. accounting rules
SEC	Securities and Exchange Commission	Enforces the U.S. accounting rules

**ILLUSTRATION 1.8****Summary of accounting abbreviations****DO IT! 3b | Accounting Standards**

Match the following terms with the correct definition.

- |  |   |
|--|---|
| a. Generally accepted accounting principles. | 1. The primary accounting standard-setting body in the United States.   |
| b. Financial Accounting Standards Board.     | 2. The agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. |
| c. Securities and Exchange Commission.       | 3. Common standards that indicate how to report economic events in the United States.                             |

**Solution**

a. 3   b. 1   c. 2

## Principles and Assumptions

Now that you know what GAAP is, let's see how businesses can interpret and apply GAAP based on some important principles and assumptions. Principles and assumptions provide a foundation for the accounting process.

GAAP generally uses one of two measurement principles: the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation.

- **Relevance** means that financial information is capable of making a difference in a decision.
- **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

### Historical Cost Principle

The **historical cost principle** (or cost principle) dictates that companies record assets at their cost.

- **Assets** are resources that a company owns.
- Companies use the historical cost principle to value assets during the time period in which the company plans to use the assets.

**EXAMPLE**

Designer Dinners purchases a new blender for \$400. As a result of the historical cost principle, Dan Johnson records the blender at \$400 in his accounting records. If Dan keeps the blender for 3 years, his records would still show a cost of \$400.

### Fair Value Principle

The **fair value principle** indicates that assets and liabilities should be reported at fair value—the price received to sell an asset or settle a liability.

- **Liabilities** are creditor claims against assets.
- Fair value information may be more useful than historical cost for certain types of assets and liabilities (see **Q&A**).
- For example, investment securities are reported at fair value because market price information is often readily available and verifiable.

### Q & A

**Q:** When doing exercises in this chapter, should I report assets at historical cost or fair value?

**A:** When reporting assets, you will use historical cost unless instructed otherwise. Fair value is used for only selected assets, such as stock investments, or in certain circumstances, such as the sale of a business, which are beyond the scope of our course.

## Monetary Unit Assumption

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms.

- This assumption enables an accountant to quantify (measure) economic events. The monetary unit assumption is vital to applying the historical cost principle.
- Keep in mind that other relevant data that is not measured in money is still important, such as the number of employees or number of company locations. However, that data will not appear in the accounting records.

### EXAMPLE

Designer Dinners provides excellent meal-preparation service to its customers. However, Dan Johnson cannot quantify this information in terms of money. Though this information is important, companies record only events that can be measured in money.

## Economic Entity Assumption

The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

- **An economic entity can be any organization or unit in society.**
- It may be a company (such as Crocs, Inc.), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (First Methodist Church).

### EXAMPLE

Dan Johnson must keep his personal living costs separate from the costs of his company, Designer Dinners.

## DO IT! 3c | Principles and Assumptions

Indicate whether each of the three statements presented below is true or false. If false, explain why.

1. The monetary unit assumption enables accountants to quantify economic events.
2. The historical cost principle dictates that companies record assets at their cost.
3. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

**Solution**

1. True.
2. True.
3. True.

## LO 3 Review and Practice

Explain the building blocks of accounting: ethics, principles, and assumptions.

### Summary

- Effective financial reporting depends on sound ethical behavior.
- Congress passed the Sarbanes-Oxley Act to reduce unethical behavior and decrease the likelihood of future corporate scandals.
- Generally accepted accounting principles (GAAP) are a common set of standards used by accountants in the United States.
- The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
- The historical cost principle dictates that companies record assets at their cost.
- The fair value principle states that assets and liabilities should be reported at fair value—the price received to sell an asset or settle a liability.
- The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money.
- The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

### Key Terms

**Assets** Resources that a company owns.

**Economic entity assumption** An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

**Ethics** The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.

**Fair value principle** An accounting principle that states that assets and liabilities should be reported at fair value—the price received to sell an asset or settle a liability.

**Faithful representation** Numbers and descriptions match what really existed or happened—they are factual.

**Financial Accounting Standards Board (FASB)** A private organization that establishes generally accepted accounting principles (GAAP) in the United States.

**Generally accepted accounting principles (GAAP)** A common set of standards used in the United States that indicates how to report economic events.

**Historical cost principle** An accounting principle that states that companies should record assets at their cost.

**Liabilities** Creditor claims against assets.

**Monetary unit assumption** An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money.

**Relevance** Financial information that is capable of making a difference in a decision.

**Sarbanes-Oxley Act (SOX)** Law passed by Congress intended to reduce unethical corporate behavior.

**Securities and Exchange Commission (SEC)** A governmental agency that oversees U.S. financial markets and accounting standard-setting bodies.

### PRACTICE 3

*Identify basic accounting assumptions and principles.*

1. Which of the following statements about basic assumptions is correct?
  - a. Basic assumptions are the same as accounting principles.
  - b. The economic entity assumption states that there should be a particular unit of accountability.
  - c. The monetary unit assumption enables accounting to measure employee morale.
  - d. Partnerships are not economic entities.
2. The historical cost principle states that:
  - a. assets should be initially recorded at cost and adjusted when the fair value changes.
  - b. activities of a business are to be kept separate and distinct from its owner.
  - c. assets should be recorded at their cost.
  - d. only transaction data capable of being expressed in terms of money should be included in the accounting records.

**Solution**

- b.** The economic entity assumption states that there should be a particular unit of accountability. The other choices are incorrect because (a) basic assumptions are not the same as accounting principles, (c) the monetary unit assumption allows accounting to measure economic events, and (d) partnerships are economic entities.
- c.** The historical cost principle states that assets should be recorded at their cost. The other choices are incorrect because (a) the historical cost principle does not say that assets should be adjusted for changes in fair value, (b) describes the economic entity assumption, and (d) describes the monetary unit assumption.

## The Four Financial Statements

### LO 4 Prepare the four financial statements.

Recall that accounting is the information system that **identifies, records, and communicates** the economic events of an organization to interested users. Companies communicate the results of their business through financial statements. These statements provide relevant financial data for internal and external users.

Companies prepare four financial statements from summarized accounting data (see

#### Helpful Hint):

1. An **income statement** presents the revenues, expenses, and resulting net income or net loss for a specific period of time.
2. An **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.
3. A **balance sheet** reports the assets, liabilities, and owner's equity at a specific date (a point in time rather than a period of time).
4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

Also, explanatory notes and supporting schedules are an integral part of every set of financial statements. We illustrate these notes and schedules throughout this text.

Be sure to carefully examine the format and content of each statement (see **Q&A**). We describe the essential features of each in the following sections. These statements are prepared in a specific order. An easy way to remember that order is shown in **Illustration 1.9**.

#### ILLUSTRATION 1.9

Memory trick for order of financial statement preparation

<u>I</u>	<u>OWN</u>	<u>BOOKS</u>	<u>@ COLLEGE</u>
Income statement	Owner's equity statement	Balance sheet	Statement of cash flows

#### Q & A

**Q:** How often are financial statements prepared?

**A:** Financial statements are prepared monthly, quarterly (every 3 months), or annually (every 12 months).

## Income Statement

The **income statement** reports the revenues and expenses for a specific period of time. The income statement starts with **revenues**—the gross increase in owner's equity resulting from business activities entered into for the purpose of earning income, such as selling merchandise, performing services, renting property, and lending money.

#### HELPFUL HINT

The income statement, owner's equity statement, and statement of cash flows are all for a *period* of time, whereas the balance sheet is for a *point* in time.

- Operations means whatever the company is in the business of doing.
- Generally, revenues result from selling merchandise, performing services, renting property, and lending money.
- The income statement is also known as the statement of earnings, profit and loss (P&L) statement, or statement of operations.

### EXAMPLE

Designer Dinners recognizes revenue when Dan Johnson performs the service of providing a cooked meal for his customer.

The income statement also reports **expenses**—the costs of doing business—that is, the costs of assets consumed or services used in the process of earning revenue.

- It costs money to provide goods or perform services.
- Expenses are recognized when costs are incurred (see **Q&A**).

### Q & A

**Q:** What does “incurred” mean?

**A:** It is a term used by accountants to indicate that an expense has occurred and needs to be recognized on the income statement (whether paid in cash or not).

### EXAMPLE

Designer Dinners recognizes expenses when Dan Johnson receives the monthly cell phone bill. Dan needs the cell phone in order to do business. Therefore, the cell phone bill is a business expense.

**Preparation** of the income statement involves the following steps:

1. Write a proper heading with the name of the company, financial statement title (in this case, Income Statement), and the period.
2. List revenues and total.
3. List expenses and total.
4. Subtract expenses from revenues.
5. If the difference is positive, the company has net income. If the difference is negative, the company has a net loss.
  - **Net income** results when revenues exceed expenses.
  - A **net loss** occurs when expenses exceed revenues.

The income statement does *not* include investment and withdrawal transactions between the owner and the business in measuring net income. **Illustration 1.10** shows the income statement for Designer Dinners.

#### ***Income Statement:***

Total revenues	\$XX
– Total expenses	<u>XX</u>
= Net income/(loss)	<u>\$XX</u>

<b>Designer Dinners</b> <b>Income Statement</b> <b>For the Month Ended October 31, 2022</b>		
Revenues		
Service revenue		\$4,700
Expenses		
Salaries and wages expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Net income		<u>\$2,750</u>

#### **ILLUSTRATION 1.10**

#### **Income statement**

The income statement provides answers to the following simple but important questions:

1. How much did the company earn in revenues?
2. How much did the company incur for expenses?
3. What is the result of revenues minus expenses?

Notice that Designer Dinners has total revenues of \$4,700 and total expenses of \$1,950. Because total revenues are greater than total expenses, Designer Dinner reports net income (total revenues minus total expenses). Also, notice that each revenue and each expense is listed separately.

### DO IT! 4a | Net Income (Loss)

Listed below are items found in the financial statements of Coastline Bed & Breakfast. Compute net income (or net loss).

Advertising expense	\$ 400
Equipment	14,900
Service revenue	15,600
Salaries and wages expense	3,500
Salaries and wages payable	2,300
Supplies	900
Rent expense	200
Cash	10,000

#### Solution

Revenues – Expenses = Net income

Service revenue \$15,600 – Advertising expense \$400 – Salaries and wages expense \$3,500 –  
Rent expense \$200 = Net income **\$11,500**

*Note:* The only data that are relevant are revenues and expenses.

## Owner's Equity Statement

The **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.

- **Owner's equity** is the ownership claim on total assets, that is, the amount of total assets remaining after creditor claims to the assets are satisfied.
- Owner's equity can also be referred to as "residual equity."

### EXAMPLE

Designer Dinners uses cash and cooking equipment for its meal-preparation services. Cash and cooking equipment are assets. If Designer Dinners borrowed money from a bank to pay for the equipment, the bank has the first claim on the assets of the company. The remaining claim on total assets of the business is owner's equity.

If the owner makes any additional investments, the company reports them in the owner's equity statement as investments. The owner's equity statement also reports **drawings**—an owner's withdrawal of cash or other assets for personal use. Drawings reduce owner's equity.

**EXAMPLE**

Dan Johnson must buy his own dinner! He may not use cash from Designer Dinners for his own personal use. If he does decide to remove cash from Designer Dinners, he must record it as a reduction of his investment. He will formally withdraw cash from this business. This is a drawing.

**Preparation** of the owner's equity statement involves the following steps:

1. Write a proper heading with the name of the company, financial statement title (in this case, Owner's Equity Statement), and the period. (Note that the time period is the same as that covered by the income statement.)
2. The first line of the statement shows the beginning owner's equity (capital) amount (which was zero at the start of the business).
3. Owner's equity increases when the owner invests money into the company.
4. Owner's equity increases when a company has net income and decreases when a company has a net loss. This amount comes from the income statement.
5. If the owner takes cash out of the business for personal use, these amounts are called drawings. Drawings reduce owner's equity.
6. The owner's equity statement shows the beginning owner's equity (capital), plus investments, plus net income or less net loss, and less drawings to arrive at an ending owner's equity (capital) for the period.

**Owner's Equity Statement:**

Beginning owner's capital	\$XX
+ Owner investment	XX
+/- Net income/loss	XX
- Owner drawings	XX
= Ending owner's capital	\$XX

**Illustration 1.11** shows the owner's equity statement for Designer Dinners.

<b>Designer Dinners</b> <b>Owner's Equity Statement</b> <b>For the Month Ended October 31, 2022</b>		
Owner's capital, October 1		\$ 0
Add: Investment		15,000
Net income		<u>2,750</u>
		17,750
Less: Drawings		<u>1,300</u>
Owner's capital, October 31		<u>\$16,450</u>

**ILLUSTRATION 1.11**

**Owner's equity statement with net income**

Because Designer Dinners began operations in October, the beginning owner's capital is \$0. Dan Johnson invested \$15,000 of his own cash. Notice that the company earned \$2,750 in net income, which is from the income statement. Dan withdrew \$1,300, which reduces owner's capital, to arrive at the ending owner's capital of \$16,450.

The owner's equity statement provides answers to the following simple but important questions:

1. How much did the owner invest into the company?
2. How much did net income or loss affect owner's equity?
3. How much did the owner withdraw from the company?

How would Designer Dinners owner's equity statement look if instead it reported a net loss of \$10,000 in its first month? Owner's capital on October 31 would be \$3,700 as shown in **Illustration 1.12**.

**ILLUSTRATION 1.12****Owner's equity statement  
with net loss**

<b>Designer Dinners</b> <b>Owner's Equity Statement</b> <b>For the Month Ended October 31, 2022</b>		
Owner's capital, October 1		\$ 0
Add: Investment		<u>15,000</u>
		15,000
Less: <b>Net loss</b>		<b>10,000</b>
Drawings		<u>1,300</u>
Owner's capital, October 31		<u><u>\$ 3,700</u></u>

## Balance Sheet

The **balance sheet** is the financial statement that reports the assets, liabilities, and owner's equity at a specific date.

- **Assets** are resources business owns, such as cash, equipment, and receivables (amounts that customers owe the business).
- **Liabilities** are creditor claims against assets, such as accounts payable and notes payable ("payable" indicates that a company must *pay* the amount in the future).
- Owner's equity is the ownership claim on total assets, as we just discussed.
- The ending owner's equity amount is from the owner's equity statement.
- The balance sheet is a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

### EXAMPLE

When Dan Johnson operates his business, Designer Dinners will have assets like cash, accounts receivable, supplies, and cooking equipment. If Dan has to pay some bills or other obligations at a later date, he will have liabilities like accounts payable or salaries and wages payable. The amount for ending owner's equity comes from the owner's equity statement.

**Preparation** of the balance sheet, assuming a "left and right" format, involves the following steps:

1. Write a proper heading with the name of the company, financial statement title (in this case, Balance Sheet), and the specific date.
2. On the *left*, list the assets.
3. On the *right*, list the liabilities.
4. Below liabilities (still on the *right*), indicate owner's equity.
5. Add the total assets on the left side, and add the total liabilities and owner's equity on the right side.
  - Total assets must equal total liabilities and owner's equity.
  - In other words, the left side must equal the right side!

<b><u>Balance Sheet:</u></b>			
Assets	\$XX	Liabilities	\$XX
		Owner's equity	<u>XX</u>
Total assets	<u><u>\$XX</u></u>	Total liabilities and owner's equity	<u><u>\$XX</u></u>
		<div style="border: 1px solid black; padding: 2px; display: inline-block;">These totals must balance!</div>	

Note that the balance sheet can also be prepared using a top-and-bottom format, rather than the left-and-right format just shown. Either format is acceptable. **Illustration 1.13** shows the balance sheet for Designer Dinners, using the top-and-bottom format.

<b>Designer Dinners</b> <b>Balance Sheet</b> <b>October 31, 2022</b>		
<u>Assets</u>		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u>\$18,050</u>
<u>Liabilities and Owner's Equity</u>		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
Owner's capital		<u>16,450</u>
Total liabilities and owner's equity		<u>\$18,050</u>

**ILLUSTRATION 1.13**

Balance sheet for Designer Dinners using a top-and-bottom format

These must be equal in order to balance!

Designer Dinners has \$18,050 in total assets and \$1,600 in total liabilities plus owner's equity of \$16,450. This amount is from the owner's equity statement.

The balance sheet provides answers to the following simple but important questions:

1. What are the assets owned by the company?
2. How much does the company owe to creditors?
3. What is the amount of owner's equity in the company?

### DO IT! 4b | Assets, Liabilities, and Owner's Equity

Listed below are items found in the financial statements of Coastline Bed & Breakfast. Compute total assets and total liabilities and owner's equity.

Advertising expense	\$ 400
Equipment	14,900
Service revenue	15,600
Salaries and wages expense	3,500
Salaries and wages payable	2,300
Owner's capital, beginning	13,400
Supplies	900
Rent expense	200
Cash	10,000
Drawings	1,400
Net income	11,500

#### Solution

Total assets = Cash \$10,000 + Supplies \$900 + Equipment \$14,900 = **\$25,800**

Total liabilities and owner's equity = Salaries and wages payable \$2,300 + Owner's equity (beginning owner's capital \$13,400 + Net income \$11,500 – Drawings \$1,400) = **\$25,800**

*Note:* Revenue and expense data are not relevant here.

## Statement of Cash Flows

The **statement of cash flows** provides information on the cash receipts and cash payments for a specific period of time.

### EXAMPLE

The statement of cash flows for Designer Dinners will provide information to explain where cash came from (cash receipts), how it was used (cash payments), and the change in cash during the period. Cash comes from customers for whom Designer Dinners performed services. Designer Dinners uses cash to pay for supplies and services received such as cell phone service.

**Preparation** of the statement of cash flows involves the following steps:

1. Write a proper heading with the name of the company, financial statement title (in this case, Statement of Cash Flows), and the period. (Note that the time period is the same as that covered by the income statement and the owner's equity statement).
2. List the cash effects of the company's operating activities during a period.
3. List the cash effects of its investing activities during a period.
4. List the cash effects of its financing activities during a period.
5. Compute the net increase or decrease in cash during the period.
6. Add the cash amount from the beginning of the period.
7. Compute the cash amount at the end of the period.

#### *Statement of Cash Flows:*

Cash from operating activities	\$XX
+/- Cash from investing activities	XX
+/- Cash from financing activities	<u>XX</u>
Net cash increase/(decrease)	XX
+ Beginning cash	<u>XX</u>
Ending cash	<u><u>\$XX</u></u>

**Illustration 1.14** shows the statement of cash flows for Designer Dinners (see **Helpful Hint**).

#### ILLUSTRATION 1.14

#### Statement of cash flows

#### HELPFUL HINT

Note that final sums are double-underlined, and negative amounts are presented in parentheses.

<b>Designer Dinners</b> <b>Statement of Cash Flows</b> <b>For the Month Ended October 31, 2022</b>		
Cash flows from operating activities		
Cash receipts from revenues		\$ 3,300
Cash payments for expenses		<u>(1,950)</u>
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Investments by owner	\$15,000	
Drawings by owner	<u>(1,300)</u>	
Net cash provided by financing activities		<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>0</u>
Cash at the end of the period		<u><u>\$ 8,050</u></u>

Notice that cash increased \$8,050 during the period. Net cash provided by operating activities increased cash \$1,350 because of the cash received and paid in daily operations. Cash flow from investing activities decreased cash \$7,000 because of the investment in equipment. Cash flow from financing activities increased cash \$13,700 because of Dan Johnson's investment of \$15,000 less his drawing of \$1,300.

The statement of cash flows provides answers to the following simple but important questions:

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

### DO IT! 4c | Cash Flows

Listed below are the items found on the statement of cash flows of Coastline Bed & Breakfast. Compute the cash amount at the end of the period, January 31, 2022.

Cash received from revenues from customers	\$14,300
Cash received by owner (investment)	10,000
Cash paid for new equipment	4,500
Cash paid to owner (drawings)	1,400
Cash paid for expenses	3,600
Cash balance, January 1, 2022	10,000

#### Solution

Operating activities	
Cash receipts from revenues	\$14,300
Cash payments for expenses	<u>(3,600)</u>
Net cash provided by operating activities	10,700
Investing activities	
Purchase of equipment	(4,500)
Financing activities	
Investments by owner	\$10,000
Drawings by owner	<u>(1,400)</u>
Net cash provided by financing activities	<u>8,600</u>
Net increase in cash	14,800
Cash at the beginning of the period	<u>10,000</u>
<b>Cash at the end of the period</b>	<b><u><u>\$24,800</u></u></b>

## The Financial Statement Connections

Recall our previous discussion of the order in which financial statements must be prepared.

1. Income statement.
2. Owner's equity statement.
3. Balance sheet.
4. Statement of cash flows.

The order is important because of the connections:

- The net income or net loss is needed from the income statement to prepare the owner's equity statement.
- The ending owner's capital is needed from the owner's equity statement to prepare the balance sheet.
- The amount of cash on the balance sheet should agree with the cash at end of period on the statement of cash flows.

Let's see how these all connect in **Illustration 1.15** (see **Helpful Hints**).

#### HELPFUL HINT

The arrows in **Illustration 1.15** show the connections of the four financial statements.

**ILLUSTRATION 1.15** The connections among the financial statements

Designer Dinners Income Statement For the Month Ended October 31, 2022		
Revenues		
Service revenue		\$4,700
Expenses		
Salaries and wages expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
<b>Net income</b>		<b><u>\$2,750</u></b>

**HELPFUL HINT**

The heading of each statement identifies the company, the type of statement, and the specific date or time period covered by the statement.

Designer Dinners Owner's Equity Statement For the Month Ended October 31, 2022		
Owner's capital, October 1		\$ 0
Add: Investment		15,000
<b>Net income</b>		<b><u>2,750</u></b>
		<u>17,750</u>
Less: Drawings		1,300
<b>Owner's capital, October 31</b>		<b><u>\$16,450</u></b>

The \$2,750 net income from the income statement is recorded on the owner's equity statement.

Designer Dinners Balance Sheet October 31, 2022		
<u>Assets</u>		
<b>Cash</b>		<b>\$ 8,050</b>
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u>\$18,050</u>
<u>Liabilities and Owner's Equity</u>		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
<b>Owner's capital</b>		<b><u>16,450</u></b>
Total liabilities and owner's equity		<u>\$18,050</u>

The \$16,450 ending balance on the owner's equity statement is reported on the balance sheet.





Designer Dinners Statement of Cash Flows For the Month Ended October 31, 2022		
Cash flows from operating activities		
Cash receipts from revenues		\$ 3,300
Cash payments for expenses		<u>(1,950)</u>
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Investments by owner	\$15,000	
Drawings by owner	<u>(1,300)</u>	
Net cash provided by financing activities		<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>0</u>
<b>Cash at the end of the period</b>		<b><u>\$ 8,050</u></b>

The cash amount of \$8,050 shown on the balance sheet should agree with the cash at the end of the period shown on the statement of cash flows.

As summarized in **Illustration 1.16**, remember that the income statement, owner’s equity statement, and statement of cash flows are all for a *period* of time (like a video). However, the balance sheet is for a *point* in time (like a photo).

**ILLUSTRATION 1.16**

**Summary of the four financial statements**

Aspect	Income Statement	Owner’s Equity Statement	Balance Sheet	Statement of Cash Flows
Period/date	Period 	Period 	Date 	Period 
Formula	Revenues – Expenses <hr/> Net income/ (net loss)	Beg. owner’s capital + Owner investment +/- Net income/loss – Owner’s drawings <hr/> End. owner’s capital	Assets = Liabilities + Owner’s Equity	Cash from operating +/- Cash from investing +/- Cash from financing <hr/> Net cash incr./ (decr.) + Beginning cash <hr/> Ending cash

This concludes our brief look at financial statements. For now, don’t worry about each line item and how each of the amounts were calculated. You will learn more details as you continue this course.

**DO IT! 4d | Financial Statement Items**

Listed below are items found in the financial statements of Coastline Bed & Breakfast. Indicate in which financial statement (income statement, owner’s equity statement, balance sheet, or statement of cash flows) the following items would appear.

- a. Advertising expense.
- b. Equipment.
- c. Service revenue.
- d. Salaries and wages expense.
- e. Salaries and wages payable.
- f. Owner’s capital, beginning.
- g. Supplies.
- h. Rent expense.
- i. Cash.
- j. Drawings.
- k. Cash paid for new equipment.

**Solution**

Item	Financial Statement
a. Advertising expense	Income statement
b. Equipment	Balance sheet
c. Service revenue	Income statement
d. Salaries and wages expense	Income statement
e. Salaries and wages payable	Balance sheet
f. Owner’s capital, beginning	Owner’s equity statement
g. Supplies	Balance sheet
h. Rent expense	Income statement
i. Cash	Balance sheet, Statement of cash flows
j. Drawings	Owner’s equity statement
k. Cash paid for new equipment	Statement of cash flows

## LO 4 Review and Practice

Prepare the four financial statements.

### Summary

- Companies communicate the results of their business through the financial statements.
- Companies prepare four financial statements from the summarized accounting data in the following order.
  1. An **income statement** presents the revenues, expenses, and resulting net income or net loss for a specific period of time.
  2. An **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.
  3. A **balance sheet** reports the assets, liabilities, and owner's equity at a specific date (a point in time rather than a period of time).
  4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time.

### Key Terms

**Balance sheet** A financial statement that reports the assets, liabilities, and owner's equity at a specific date.

**Drawings** Owner's withdrawals of cash or other assets for personal use; decrease owner's equity.

**Expenses** The cost of assets consumed or services used in the process of earning revenue; decrease owner's equity from operating the business.

**Income statement** A financial statement that presents the revenues, expenses, and resulting net income or net loss of a company for a specific period of time.

**Net income** The amount by which revenues exceed expenses.

**Net loss** The amount by which expenses exceed revenues.

**Owner's equity** The ownership claim on total assets, that is, the amount of total assets remaining after creditor claims to the assets are satisfied.

**Owner's equity statement** A financial statement that summarizes the changes in owner's equity for a specific period of time.

**Revenues** The gross increase in owner's equity resulting from business activities entered into for the purpose of earning income, such as selling merchandise, performing services, renting property, and lending money.

**Statement of cash flows** A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time.

### PRACTICE 4

*Classify items by financial statement.*

Listed below are some items found in the financial statements of Sundown Boutique. Indicate in which financial statement (income statement, owner's equity statement, balance sheet, or statement of cash flows) the following items would appear.

- |                          |                                |
|--------------------------|--------------------------------|
| a. Cash.                 | f. Equipment.                  |
| b. Accounts payable.     | g. Salaries and wages payable. |
| c. Owner's drawings.     | h. Service revenue.            |
| d. Net increase in cash. | i. Rent expense.               |
| e. Supplies.             | j. Cash invested by owner.     |

### Solution

Item	Financial Statement
a. Cash	Balance sheet, Statement of cash flows
b. Accounts payable	Balance sheet
c. Owner's drawings	Owner's equity statement
d. Net increase in cash	Statement of cash flows
e. Supplies	Balance sheet
f. Equipment	Balance sheet
g. Salaries and wages payable	Balance sheet
h. Service revenue	Income statement
i. Rent expense	Income statement
j. Cash invested by owner	Owner's equity statement, Statement of cash flows

# Careers in Accounting

**LO 5** Name career opportunities in accounting.

Now that you have a new understanding of what accounting is and who uses accounting information, are you curious about a possible career in accounting? There are many jobs and opportunities available to you.

- In many cities, the demand for accountants far exceeds the supply.
- Accounting offers many different jobs in fields such as public, private, governmental, and forensic accounting.

## Public Accounting

Individuals in **public accounting** offer professional service to the general public, in much the same way that doctors treat patients and lawyers counsel clients. There are three main job opportunities in public accounting:

### 1. Auditing.

- In **auditing**, a certified public accountant (CPA) examines company financial statements in order to express an opinion as to the fairness of presentation (see **FYI**).
- Analysts, investors, and creditors rely heavily on these “audit opinions,” which CPAs have the exclusive authority to issue.

### 2. Taxation.

- In **taxation**, tax specialists provide tax advice, planning, and return services.
- Tax specialists sometimes represent clients before governmental agencies such as the Internal Revenue Service (IRS).

### 3. Management consulting.

- **Management consulting** includes installing accounting software or enterprise resource planning systems.
- Management consultants sometimes perform support services for major marketing projects and merger and acquisition activities.

Many CPAs are entrepreneurs. They form small- or medium-size practices that frequently specialize in tax or consulting services.

### FYI

Are you interested in how to get your CPA license? Check out the NASBA (National Association of State Boards of Accountancy) and the AICPA (American Institute of CPAs) websites. Do a search for the State Board of Accountancy for your state for more specific information.

## Private Accounting

Instead of working in public accounting, you might choose to be an accountant for a for-profit company such as Starbucks, Google, or PepsiCo, or for non-for-profit organizations such as the Red Cross, Bill and Melinda Gates Foundation, museums, libraries, or performing arts organizations.

- In **private (managerial) accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, and tax planning and preparation (see **FYI**).

- You might also be a member of your company's internal audit team.
- In response to the Sarbanes-Oxley Act, the internal auditors' job of reviewing company operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

### FYI

If you are interested in private accounting, you should consider one of the following certifications: CMA (certified managerial accountant), CGMA (chartered global management accountant), or CIA (certified internal auditor).

## Governmental Accounting

Another option is to pursue one of the many accounting opportunities in governmental agencies.

- For example, the Internal Revenue Service (IRS), Federal Bureau of Investigation (FBI), and the Securities and Exchange Commission (SEC) all employ accountants.
- The FBI has a stated goal that at least 15% of its new agents should be CPAs.
- There is a very high demand for accounting educators at public colleges and universities.
- State and local governments employ accountants.

## Forensic Accounting

**Forensic accounting** has been listed among the top 20 career paths of the future. It uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud.

- The job of forensic accountants is to catch the perpetrators of the estimated \$600 billion per year of theft and fraud occurring at U.S. companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion.
- Insurance companies hire forensic accountants to detect frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.
- Forensic accountants often have FBI, IRS, or similar government experience.
- Forensic accountants can get a certification called a CFE (certified fraud examiner).

How much can a new accountant make? A junior-level public accountant at a large firm can make over \$75,000. A college graduate who works in a small company's accounting department can make over \$50,000.

### DO IT! 5 | Public Accounting and Accounting Careers

1. Services performed by a public accountant include:
  - a. auditing, taxation, and management consulting.
  - b. auditing, budgeting, and management consulting.
  - c. auditing, budgeting, and cost accounting.
  - d. auditing, cost accounting, and management consulting.
2. In which area would you work if your primary focus is to investigate financial fraud?
  - a. Governmental accounting.
  - b. Public accounting.
  - c. Private accounting.
  - d. Forensic accounting.

**Solution**

1. **a.** Auditing, taxation, and management consulting are all services performed by public accountants. The other choices are incorrect because public accountants do not perform budgeting or cost accounting.
2. **d.** Forensic accounting conducts investigations into theft and fraud. The other choices are incorrect because they are not focused on fraud.

## LO 5 Review and Practice

Name career opportunities in accounting.

### Summary

- Accounting is a popular major because there are many different types of jobs with a wide array of opportunities.
- Accounting offers many different jobs in fields such as public, private, governmental, and forensic accounting.

### Key Terms

**Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation.

**Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud.

**Management consulting** An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities.

**Private (managerial) accounting** An area of accounting within a company that involves such activities as cost accounting, budgeting, design

and support of accounting information systems, and tax planning and preparation.

**Public accounting** An area of accounting in which the accountant offers professional service to the general public.

**Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies.

### PRACTICE 5

*Match accounting careers with their description.*

Listed below are the possible career options in accounting and definitions of each. Match the correct definitions to each career option.

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>a. Forensic accounting.</li> <li>b. Taxation.</li> <li>c. Public accounting.</li> <li>d. Auditing.</li> <li>e. Management consulting.</li> <li>f. Private accounting.</li> </ul> | <ul style="list-style-type: none"> <li>1. An area of public accounting involving tax advice, tax planning, and preparing tax returns.</li> <li>2. An area of accounting in which the accountant offers professional service to the general public.</li> <li>3. An area of accounting within a company that involves such activities as cost accounting, budgeting, and tax planning and preparation.</li> <li>4. An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects.</li> <li>5. An area of accounting that conducts investigations into theft and fraud.</li> <li>6. The examination of financial statements by a certified public accountant in order to express an opinion.</li> </ul> |
|---|--|

**Solution**

- a. 5   b. 1   c. 2   d. 6   e. 4   f. 3**

# Comprehensive Review and Practice

## Learning Objectives Review

### 1 Identify the activities and users associated with accounting.

- Accounting is the language of business.
- In business, accounting and financial statements are the means for communicating the numbers.
- Accounting is the information system that identifies, records, and communicates the economic events of an organization to interested users.
- The major users of accounting information are internal and external users.
- Internal users of accounting information are managers who plan, organize, and run the business.
- External users are individuals and organizations outside a company who want financial information about the company.

### 2 Identify the types of businesses associated with accounting.

- There are three types of business entities: proprietorship, partnership, and corporation.
  1. A proprietorship is a business owned by one person.
  2. A partnership is a business owned by two or more people.
  3. A corporation is a business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock.
- Businesses can be classified based on the operations of the business: service, retail (merchandising), and manufacturing companies.
  - A service company performs a service for customers.
  - A retail, or merchandising, company sells products to customers in the form in which the company purchased them.
  - A manufacturing company converts raw materials into finished goods to sell to customers.

### 3 Explain the building blocks of accounting: ethics, principles, and assumptions.

- Effective financial reporting depends on sound ethical behavior.
- Congress passed the Sarbanes-Oxley Act to reduce unethical behavior and decrease the likelihood of future corporate scandals.

- Generally accepted accounting principles (GAAP) are a common set of standards used by accountants.
- The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
- The historical cost principle dictates that companies record assets at their cost.
- The fair value principle states that assets and liabilities should be reported at fair value—the price received to sell an asset or settle a liability.
- The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money.
- The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

### 4 Prepare the four financial statements.

- Companies communicate the results of their business through the financial statements.
- Companies prepare four financial statements from the summarized accounting data in the following order.
  1. An **income statement** presents the revenues, expenses, and resulting net income or net loss for a specific period of time.
  2. An **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.
  3. A **balance sheet** reports the assets, liabilities, and owner's equity at a specific date (a point in time rather than a period of time).
  4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time.

### 5 Name career opportunities in accounting.

- Accounting is a popular major because there are many different types of jobs with a wide array of opportunities.
- Accounting offers many different jobs in fields such as public, private, governmental, and forensic accounting.

## Key Terms

**Accounting** The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 1-2).

**Assets** Resources that a company owns. (p. 1-13).

**Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 1-27).

**Balance sheet** A financial statement that reports the assets, liabilities, and owner's equity at a specific date. (p. 1-20).

**Bookkeeping** A part of the accounting process that involves only the recording of economic events. (p. 1-3).

**Corporation** A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock. (p. 1-8).

**Drawings** Owner's withdrawals of cash or other assets for personal use; decrease owner's equity. (p. 1-18).

**Economic entity assumption** An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. (p. 1-14).

**Ethics** The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 1-11).

**Expenses** The cost of assets consumed or services used in the process of earning revenue; decrease owner's equity from operating the business. (p. 1-17).

**Fair value principle** An accounting principle that states that assets and liabilities should be reported at fair value—the price received to sell an asset or settle a liability. (p. 1-13).

**Faithful representation** Numbers and descriptions match what really existed or happened—they are factual. (p. 1-13).

**Financial accounting** The field of accounting that provides economic and financial information for investors, creditors, and other external users. (p. 1-5).

**Financial Accounting Standards Board (FASB)** A private organization that establishes generally accepted accounting principles (GAAP) in the United States. (p. 1-12).

**Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-28).

**Generally accepted accounting principles (GAAP)** A common set of standards used in the United States that indicates how to report economic events. (p. 1-12).

**Historical cost principle** An accounting principle that states that companies should record assets at their cost. (p. 1-13).

**Income statement** A financial statement that presents the revenues, expenses, and resulting net income or net loss of a company for a specific period of time. (p. 1-16).

**Liabilities** Creditor claims against assets. (p. 1-14).

**Management consulting** An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 1-27).

**Managerial accounting** The field of accounting that provides internal reports to help users make decisions about their companies. (p. 1-4).

**Manufacturing company** A business that converts raw materials into finished goods to sell to customers. (p. 1-9).

**Monetary unit assumption** An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money. (p. 1-14).

**Net income** The amount by which revenues exceed expenses. (p. 1-17).

**Net loss** The amount by which expenses exceed revenues. (p. 1-17).

**Owner's equity** The ownership claim on total assets, that is, the amount of total assets remaining after creditor claims to the assets are satisfied. (p. 1-18).

**Owner's equity statement** A financial statement that summarizes the changes in owner's equity for a specific period of time. (p. 1-18).

**Partnership** A business owned by two or more persons associated as partners. (p. 1-8).

**Private (managerial) accounting** An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation. (p. 1-27).

**Proprietorship** A business owned by one person. (p. 1-7).

**Public accounting** An area of accounting in which the accountant offers professional service to the general public. (p. 1-27).

**Relevance** Financial information that is capable of making a difference in a decision. (p. 1-13).

**Retail (merchandise) company** A business that sells products to customers in the form in which they were purchased. (p. 1-9).

**Revenues** The gross increase in owner's equity resulting from business activities entered into for the purpose of earning income, such as selling merchandise, performing services, renting property, and lending money. (p. 1-16).

**Sarbanes-Oxley Act (SOX)** Law passed by Congress intended to reduce unethical corporate behavior. (p. 1-11).

**Securities and Exchange Commission (SEC)** A governmental agency that oversees U.S. financial markets and accounting standard-setting bodies. (p. 1-12).

**Service company** A business that performs a service for customers. (p. 1-9).

**Statement of cash flows** A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time. (p. 1-22).

**Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-27).

## Practice Multiple-Choice Questions

- (LO 1)** Accounting is the system that:
  - identifies and records economic events.
  - records and communicates economic events.
  - identifies, records, and communicates economic events.
  - None of the answer choices are correct.
- (LO 1)** The major users of accounting information are:
  - internal and external users.
  - creditors and investors.
  - managers and creditors.
  - the IRS and the SEC.
- (LO 2)** A proprietorship is a business that:
  - has limited liability.
  - is owned by one person.
  - has an unlimited life.
  - is owned by shareholders.
- (LO 3)** The goal of the Sarbanes-Oxley Act was to:
  - decrease the likelihood of future corporate scandals.
  - increase penalties for fraudulent activity.
  - reduce unethical behavior.
  - All of the answer choices are correct.
- (LO 3)** GAAP stands for:
  - generally accepted accounting procedures.
  - generally accepted auditing principles.
  - generally accepted auditing procedures.
  - generally accepted accounting principles.
- (LO 4)** The formula for the income statement is:
  - Revenues + Expenses = Net Income
  - Revenues – Expenses = Net Income
  - Revenues – Expenses – Drawings = Net Income
  - Revenues – Drawings = Net Income

7. (LO 4) The three sections on the balance sheet are:
- Assets, Liabilities, and Owner's Equity.
  - Assets, Drawings, and Revenues.
  - Revenues, Expenses, and Owner's Equity.
  - Investments, Drawings, and Assets.
8. (LO 4) Which of the following statements is false?
- A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
  - A balance sheet reports the assets, liabilities, and owner's equity at a specific date.
  - An income statement presents the revenues, expenses, changes in owner's equity, and resulting net income or net loss for a specific period of time.
  - An owner's equity statement summarizes the changes in owner's equity for a specific period of time.
9. (LO 4) The order in which the financial statements are prepared is:
- income statement, balance sheet, owner's equity statement, and statement of cash flows.
  - owner's equity statement, income statement, balance sheet, and statement of cash flows.
  - statement of cash flows, income statement, owner's equity statement, and balance sheet.
  - income statement, owner's equity statement, balance sheet, and statement of cash flows.
10. (LO 5) A tax specialist works in:
- governmental accounting.
  - private accounting.
  - public accounting.
  - forensic accounting.

## Solutions

1. c. The definition of accounting is the system that identifies, records, and communicates economic events. The other choices are incomplete.
2. a. The major users of accounting information are internal and external users. The other choices are incorrect because (b) creditors and investors provide only examples of external users, (c) managers (internal users) and creditors (external users) only provide some examples of internal and external users, and (d) the IRS and SEC provide only examples of external users.
3. b. A proprietorship is a business owned by one person. The other choices are incorrect because (a) limited liability, (c) unlimited life, and (d) owned by shareholders are all characteristics of a corporation.
4. d. The goal of the Sarbanes-Oxley Act was to decrease the likelihood of future corporate scandals, to increase penalties for fraudulent activity, and to reduce unethical behavior.
5. d. GAAP stands for generally accepted accounting principles. The other choices are therefore incorrect.
6. b. The formula for the income statement is Revenues – Expenses = Net Income. The other choices are incorrect because (a) expenses are subtracted rather than added, and (c) and (d) drawings are not included on the income statement.
7. a. The three sections on the balance sheet are Assets, Liabilities, and Owner's Equity. The other choices are incorrect because (b) drawings and revenues are not on the balance sheet, (c) revenues and expenses are not on the balance sheet, and (d) investments and drawings are not on the balance sheet.
8. c. An income statement represents the revenues, expenses, and the resulting net income or net loss for a specific period of time but not the changes in owner's equity. The other choices are true statements.
9. d. The order in which the financial statements are prepared is income statement, owner's equity statement, balance sheet, and statement of cash flows. The other choices are therefore incorrect.
10. c. A tax specialist works in public accounting. The other choices are therefore incorrect.

## Practice Exercises

Indicate internal and external users.

1. (LO 1) Various users of financial information are listed below.
- |                                   |                                |
|-----------------------------------|--------------------------------|
| a. Marketing manager.             | f. Creditor.                   |
| b. IRS.                           | g. Human resources supervisor. |
| c. CEO (chief executive officer). | h. SEC.                        |
| d. Banker.                        | i. Finance director.           |
| e. Investor.                      |                                |

### Instructions

Indicate whether each is an internal user or external user.

## Solution

1. a. Marketing manager: Internal user                      f. Creditor: External user
- b. IRS: External user                                      g. Human resources supervisor: Internal user
- c. CEO (chief executive officer): Internal user      h. SEC: External user
- d. Banker: External user                                i. Finance director: Internal user
- e. Investor: External user

2. (LO 3) Various terms from this chapter are listed below.

*Match terms with definitions.*

1. Sarbanes-Oxley Act (SOX).
2. Ethics.
3. Faithful representation.
4. Monetary unit assumption.
5. Fair value principle.
6. Relevance.
7. Historical cost principle.
8. Economic entity assumption.

### Instructions

Match the appropriate following definitions with the terms listed above.

- a. Numbers and descriptions match what really existed or happened—they are factual.
- b. An accounting principle that states that companies should record assets at their cost.
- c. Law passed by Congress intended to reduce unethical corporate behavior.
- d. Financial information that is capable of making a difference in a decision.
- e. An accounting principle that states that assets and liabilities should be reported at fair value—the price received to sell an asset or settle a liability.
- f. An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money.
- g. The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.
- h. An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

## Solution

2. a. 3   b. 7   c. 1   d. 6   e. 5   f. 4   g. 2   h. 8

## Practice Problem

- (LO 4) The following data is from Martin Jackson's Skate Park for the month ended October 31, 2022.

*Prepare financial statements.*

Owner's equity as of October 1, 2022	\$15,000	Drawings	\$ 600
Rent expense	600	Accounts payable	500
Equipment	14,200	Salaries and wages expense	2,500
Advertising expense	700	Investment by owner	4,000
Supplies	900	Purchase of equipment	(5,100)
Service revenue	10,000	Cash receipts from revenues	4,500
Cash	3,000	Cash payments for expenses	(3,300)
Accounts receivable	7,000	Cash at October 1, 2022	3,500

### Instructions

- a. Prepare an income statement.
- b. Prepare an owner's equity statement.
- c. Prepare a balance sheet.
- d. Prepare a statement at cash flows.

## Solution

a.

<b>Martin Jackson's Skate Park Income Statement For the Month Ended October 31, 2022</b>		
Revenues		
Service revenue		\$10,000
Expenses		
Salaries and wages expense	\$2,500	
Advertising expense	700	
Rent expense	<u>600</u>	
Total expenses		<u>3,800</u>
Net income		<u>\$ 6,200</u>

b.

<b>Martin Jackson's Skate Park Owner's Equity Statement For the Month Ended October 31, 2022</b>		
Owner's capital, October 1		\$15,000
Add: Investments		4,000
Net income		<u>6,200</u>
		25,200
Less: Drawings		<u>600</u>
Owner's capital, October 31		<u>\$24,600</u>

c.

<b>Martin Jackson's Skate Park Balance Sheet October 31, 2022</b>		
<u>Assets</u>		
Cash		\$ 3,000
Accounts receivable		7,000
Supplies		900
Equipment		<u>14,200</u>
Total assets		<u>\$25,100</u>
<u>Liabilities and Owner's Equity</u>		
Liabilities		
Accounts payable		\$ 500
Owner's equity		
Owner's capital		<u>24,600</u>
Total liabilities and owner's equity		<u>\$25,100</u>

d.

<b>Martin Jackson's Skate Park Statement of Cash Flows For the Month Ended October 31, 2022</b>		
Cash flows from operating activities		
Cash receipts from revenues		\$ 4,500
Cash payments for expenses		<u>(3,300)</u>
Net cash provided by operating activities		1,200
Cash flows from investing activities		
Purchase of equipment		(5,100)
Cash flows from financing activities		
Investment by owner	\$4,000	
Drawings by owner	<u>(600)</u>	
Net cash provided by financing activities		<u>3,400</u>
Net decrease in cash		(500)
Cash at the beginning of the period		<u>3,500</u>
Cash at the end of the period		<u>\$ 3,000</u>

## WileyPLUS

Questions, Brief Exercises, DO IT! Exercises, Exercises, Problems, and additional resources are available for practice in WileyPLUS.

### Questions

- “Accounting is ingrained in our society and it is vital to our economic system.” Do you agree? Explain.
- Identify and describe the steps in the accounting process.
- “Bookkeeping and accounting are the same.” Do you agree? Explain.
- Who are internal users of accounting data?
  - How does accounting provide relevant data to these users?
- What uses of financial accounting information are made by investors?
  - What uses of financial accounting information are made by creditors?
- What are the three basic forms of business organizations for profit-oriented enterprises?
- Trenton Travel Agency purchased land for \$90,000 cash on December 10, 2022. At December 31, 2022, the land’s value has increased to \$93,000. What amount should be reported for land on Trenton’s balance sheet at December 31, 2022? Explain.
- What is the monetary unit assumption?
- What is the economic entity assumption?
- Rachel Hipp is the owner of a successful printing shop. Recently, her business has been increasing, and Rachel has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Rachel would enjoy if she were to incorporate her business.
- Listed below are some items found in the financial statements of Tony Gruber Co. Indicate in which financial statement(s) the following items would appear.
 

a. Service revenue.	d. Accounts receivable.
b. Equipment.	e. Owner’s capital.
c. Advertising expense.	f. Salaries and wages payable.
- In February, Maria Osgood invested an additional \$10,000 in her business, Osgood’s Pharmacy, which is organized as a proprietorship. Osgood’s accountant, Carl, recorded this as revenue on the income statement. Is this treatment appropriate? Why or why not?
- “A company’s net income appears directly on the income statement and the owner’s equity statement, and it is included indirectly in the company’s balance sheet.” Do you agree? Explain.
- Saylor Enterprises had an owner’s capital balance of \$168,000 at the beginning of the period. At the end of the accounting period, the owner’s capital balance was \$198,000.
  - Assuming no additional investment or withdrawals during the period, what is the net income for the period?
  - Assuming an additional investment of \$13,000 but no withdrawals during the period, what is the net income for the period?
- Summarized operations for Bayles Co. for the month of July are as follows.
 

Revenues	\$70,000.
Expenses	\$40,000.

Indicate for Bayles Co. the net income for the month of July.

- List three job opportunities in public accounting.

### Brief Exercises

**BE1.1 (LO 4), C** Diehl Cleaners has the following balance sheet items. Classify each item as an asset, liability, or owner’s equity.

Accounts payable	Accounts receivable
Cash	Notes payable
Equipment	Salaries and wages payable
Supplies	Owner’s capital

*Classify balance sheet items as assets, liabilities, and owner’s equity.*

Determine where items appear on financial statements.

**BE1.2 (LO 4), C** Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or owner's equity statement (OE).

- |                         |                     |
|-------------------------|---------------------|
| a. Notes payable.       | d. Cash.            |
| b. Advertising expense. | e. Service revenue. |
| c. Owner's capital.     |                     |

Prepare a balance sheet.

**BE1.3 (LO 4), AP** In alphabetical order below are balance sheet items for Mendoza Company at December 31, 2022. Kathy Mendoza is the owner of Mendoza Company. Prepare a balance sheet, following the format of Illustration 1.13.

Accounts payable	\$90,000
Accounts receivable	72,500
Cash	49,000
Owner's capital	31,500

Prepare an income statement and owner's equity statement.

**BE1.4 (LO 4), AP** The following information relates to Armanda Co. for the year 2022. After analyzing the data, prepare an income statement and an owner's equity statement for the year ending December 31, 2022.

Owner's capital, January 1, 2022	\$48,000	Advertising expense	\$ 1,800
Owner's drawings during 2022	6,000	Rent expense	10,400
Service revenue	63,600	Utilities expense	3,100
Salaries and wages expense	29,500		

Determine where items appear on the financial statements.

**BE1.5 (LO 4), C** Indicate where in the financial statements you would find the following items— income statement (IS), owner's equity statement (OE), or balance sheet (BS).

- |                  |                         |                      |
|------------------|-------------------------|----------------------|
| a. Drawings.     | c. Advertising expense. | e. Supplies.         |
| b. Rent revenue. | d. Owner investment.    | f. Accounts payable. |

Compute net change in cash on statement of cash flows.

**BE1.6 (LO 4), AP** Compute the net change in cash on the statement of cash flows given the following data.

Cash flows from operating activities	\$ 5,890
Cash flows from investing activities	(3,500)
Cash flows from financing activities	1,400

## DO IT! Exercises

Review basic concepts.

**DO IT! 1.1 (LO 1), K** Indicate whether each of the following statements is true or false. If false, indicate how to correct the statement.

- The three steps in the accounting process are identification, recording, and examination.
- The accounting process includes the bookkeeping function.
- Managerial accounting provides reports to help investors and creditors evaluate a company.
- The two most common types of external users are investors and creditors.
- Internal users include human resources managers.

Identify types and classifications of businesses.

**DO IT! 1.2 (LO 2), K** Indicate whether each of the following statements is true or false. If false, indicate how to correct the statement.

- A business owned by two or more persons associated as partners is a corporation.
- A business owned by one person is generally a proprietorship.
- A merchandising company converts raw materials into finished goods to sell to customers.
- A landscaping company is an example of a service company.
- A department store is an example of a manufacturing company.

Identify building blocks of accounting.

**DO IT! 1.3 (LO 3), K** Indicate whether each of the following statements is true or false. If false, indicate how to correct the statement.

- Congress passed the Sarbanes-Oxley Act to ensure that investors invest only in companies that will be profitable.
- The standards of conduct by which actions are judged as loyal or disloyal are ethics.

3. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
4. The historical cost principle dictates that companies record assets at their cost and continue to report them at their cost over the time the assets are held.
5. The monetary unit assumption requires that companies record only transactions that can be measured in monetary units.

**DO IT! 1.4 (LO 4), AN** Presented below is selected information related to Kirby Company at December 31. Kirby reports financial information monthly.

*Determine specific amounts in the financial statements.*

Accounts payable	\$ 3,000	Rent expense	\$10,500
Cash	6,500	Accounts receivable	13,500
Advertising expense	6,000	Owner's drawings	7,500
Service revenue	53,500	Net cash provided by	
Equipment	29,000	operating activities	14,600
Salaries and wages expense	16,500	Purchase of equipment	(13,800)
Notes payable	25,000	Net cash provided by	
		financing activities	2,200

- a. Determine the total assets of Kirby Company at December 31.
- b. Determine the net income that Kirby Company reported for December.
- c. Determine the owner's equity of Kirby Company at December 31.
- d. Determine the cash balance of Kirby Company at December 1 (beginning cash).

**DO IT! 1.5 (LO 5), K** From the following list of services, identify the four services performed by a private accountant: auditing, budgeting, cost accounting, management consulting, tax planning, and tax preparation.

*Identify accounting services.*

## Exercises

**E1.1 (LO 1), C** Genesis Company performs the following accounting tasks during the year.

*Classify the three activities of accounting.*

- a. Analyzing and interpreting information.
- b. Classifying economic events.
- c. Explaining uses, meaning, and limitations of data.
- d. Keeping a systematic chronological diary of events.
- e. Measuring events in dollars and cents.
- f. Preparing accounting reports.
- g. Reporting information in a standard format.
- h. Selecting economic activities relevant to the company.
- i. Summarizing economic events.

Accounting is "an information system that **identifies, records, and communicates** the economic events of an organization to interested users."

### Instructions

Categorize the accounting tasks performed by Genesis as relating to either the identification (I), recording (R), or communication (C) of economic events.

**E1.2 (LO 1), C a.** The following are users of financial statements.

*Identify users of accounting information.*

1. Customers.
2. Internal Revenue Service.
3. Labor unions.
4. Marketing manager.
5. Production supervisor.
6. Securities and Exchange Commission.
7. Store manager.
8. Suppliers.
9. Vice president of finance.

**Instructions**

Identify the users as being either **external users** or **internal users**.

- b. The following questions could be asked by an internal user or an external user.
  1. Can we afford to give our employees a pay raise?
  2. Did the company earn a satisfactory income?
  3. Do we need to borrow in the near future?
  4. How does the company’s profitability compare to other companies?
  5. What does it cost us to manufacture each unit produced?
  6. Which product should we emphasize?
  7. Will the company be able to pay its short-term debts?

**Instructions**

Identify each of the questions as being more likely asked by an **internal user** or an **external user**.

*Identify types of companies.*

**E1.3 (LO 2), K** The following are examples of types of companies.

- a. Interior design firm.
- b. Sporting goods store.
- c. Pharmacy.
- d. Chemical plant.
- e. Computer repair business.
- f. Furniture factory.

**Instructions**

Identify each of the companies as service, merchandising, or manufacturing.

*Identify principles or assumptions.*

**E1.4 (LO 3), C** The following situations involve accounting principles and assumptions.

1. Tisinai Company owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Tisinai reports the buildings at fair value in its accounting reports.
2. Kingston Company includes in its accounting records only transaction data that can be expressed in terms of money.
3. Roger Holloway, owner of Roger’s Photography, records his personal living costs as expenses of the business.

**Instructions**

For each of the three situations, indicate if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

*Correct an incorrectly prepared balance sheet.*

**E1.5 (LO 4), AN** Abby Roland is the bookkeeper for Cheng Company. Abby has been trying to determine the correct balance sheet for the company. Cheng Company’s balance sheet is shown below.

<b>Cheng Company Balance Sheet December 31, 2022</b>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$15,000	Accounts payable	\$21,000
Supplies	8,000	Accounts receivable	(6,500)
Equipment	46,000	Owner’s capital	<u>67,500</u>
Owner’s drawings	<u>13,000</u>	Total liabilities and owner’s equity	<u>\$82,000</u>
Total assets	<u>\$82,000</u>		

**Instructions**

Prepare a correct balance sheet.

*Compute net income and prepare a balance sheet.*

**E1.6 (LO 4), AP** Loren Satina is the only owner of Clear View Park, a public camping ground near the Lake Mead National Recreation Area. Loren has compiled the following financial information as of December 31, 2022.

Service revenues during 2022	\$205,000	Fair value of equipment	\$140,000
Accounts payable	11,000	Notes payable	60,000
Cash on hand	23,000	Expenses during 2022	150,000
Original cost of equipment	105,500	Accounts receivable	17,500

**Instructions**

- Determine Loren Satina's net income from Clear View Park for 2022.
- Prepare a balance sheet for Clear View Park as of December 31, 2022.

**E1.7 (LO 4), AP** Presented below is financial information related to the 2022 operations of Sea Legs Cruise Company. *Prepare an income statement.*

Rent expense	\$ 95,000
Utilities expense	13,000
Salaries and wages expense	142,000
Advertising expense	24,500
Service revenue	410,000

**Instructions**

Prepare the 2022 income statement for Sea Legs Cruise Company.

**E1.8 (LO 4), AP** Presented below is information related to the proprietorship of Alice Henning, attorney. *Prepare an owner's equity statement.*

Service revenue—2022	\$335,000
Total expenses—2022	211,000
Assets, January 1, 2022	96,000
Liabilities, January 1, 2022	62,000
Assets, December 31, 2022	168,000
Liabilities, December 31, 2022	100,000
Drawings—2022	?

**Instructions**

Prepare the 2022 owner's equity statement for Alice Henning's legal practice.

**E1.9 (LO 4), AP** Presented below is financial information for Skyline Company. *Prepare a statement of cash flows.*

Cash received from revenues from customers	\$12,800
Cash received by owner (investment)	4,000
Cash paid for new equipment	2,340
Cash paid to owner (drawings)	2,700
Cash paid for expenses	9,500
Cash balance, December 1, 2022	3,000

**Instructions**

Prepare a statement of cash flows for the month ended December 31, 2022.

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## Problems

**P1.1 (LO 4), AP** On June 1, Cindy Godfrey started Divine Designs Co., a company that provides craft opportunities, by investing \$12,000 cash in the business. Following are the assets and liabilities of the company at June 30 and the revenues and expenses for the month of June. *Prepare an income statement, owner's equity statement, and balance sheet.*

Cash	\$10,150	Accounts payable	\$1,200
Accounts receivable	2,800	Service revenue	6,500
Supplies	2,000	Advertising expense	500
Equipment	10,000	Rent expense	1,600
Notes payable	9,000	Utilities expense	350

Cindy made no additional investment in June but withdrew \$1,300 in cash for personal use during the month.

**Instructions**

Prepare an income statement and owner's equity statement for the month of June and a balance sheet at June 30, 2022.

Determine financial statement amounts and prepare an owner's equity statement.

**P1.2 (LO 4), AN** Financial statement information about four different companies is as follows.

	<u>Alpha Company</u>	<u>Beta Company</u>	<u>Psi Company</u>	<u>Omega Company</u>
January 1, 2022				
Assets	\$ 80,000	\$ 90,000	(g)	\$150,000
Liabilities	41,000	(d)	80,000	(j)
Owner's equity	(a)	40,000	49,000	90,000
December 31, 2022				
Assets	(b)	112,000	170,000	(k)
Liabilities	60,000	72,000	(h)	100,000
Owner's equity	50,000	(e)	82,000	151,000
Owner's equity changes in year				
Additional investment	(c)	8,000	10,000	15,000
Drawings	15,000	(f)	12,000	10,000
Total revenues	350,000	410,000	(i)	500,000
Total expenses	333,000	385,000	350,000	(l)

### Instructions

- Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets – Liabilities = Owner's equity = \$39,000.)
- Prepare the owner's equity statement for Alpha Company.
- Write a memorandum explaining the sequence for preparing financial statements and the inter-relationship of the owner's equity statement to the income statement and balance sheet.

Prepare a statement of cash flows.

**P1.3 (LO 4), AP** This information is for Paulo Company for the year ended December 31, 2022.

Cash received from revenues from customers	\$600,000
Cash received by owner (investment)	280,000
Cash paid for new equipment	115,000
Cash paid to owner (drawings)	18,000
Cash paid for expenses	430,000
Cash balance, January 1, 2022	30,000

### Instructions

Prepare the 2022 statement of cash flows for Paulo Company.

## Continuing Case



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### Cookie Creations

Go to **WileyPLUS** for complete case details and instructions.

# Expand Your Critical Thinking

## Real-World Focus

**CT1.1** This exercise will familiarize you with the non-accounting skills needed to be a successful accountant.

### Instructions

Search the Internet for “start here go places” to access free accounting resources for future CPAs, click on CPA skills, and then answer the following questions.

- What are the four skill sets that are useful for success in accounting?
- Why are these skill sets useful for a successful accounting career?

## Decision-Making across the Organization

**CT1.2** Anya and Nick Ramon, local golf stars, opened the Chip-Shot Driving Range on March 1, 2022, by investing \$25,000 of their cash savings in the business. Equipment was purchased with cash for \$8,800. The Ramons leased five acres of land at a cost of \$1,000 per month and paid the first month’s rent. During the first month, advertising costs totaled \$750, of which \$100 was unpaid at March 31, and \$500 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company’s bank account. On March 15, Anya and Nick withdrew a total of \$1,000 in cash for personal living expenses. A \$120 utility bill was received on March 31 but was not paid. On March 31, the balance in the company’s bank account was \$18,900.

Anya and Nick thought they had a pretty good first month of operations, but their estimates of profitability ranged from a loss of \$6,100 to net income of \$2,480.

### Instructions

With the class divided into groups, answer the following.

- How could the Ramons have concluded that the business operated at a loss of \$6,100? Was this a valid basis on which to determine net income?
- How could the Ramons have concluded that the business operated at a net income of \$2,480? (*Hint:* Prepare a balance sheet at March 31.) Was this a valid basis on which to determine net income?
- Without preparing an income statement, determine the actual net income for March.
- What was the revenue recognized in March?

## Communication Activity

**CT1.3** Sandi Alcon, the bookkeeper for New York Company, has been trying to determine the correct balance sheet for the company. The company’s balance sheet is shown below.

New York Company Balance Sheet For the Month Ended December 31, 2022			
Assets		Liabilities	
Equipment	\$25,500	Owner’s capital	\$26,000
Cash	9,000	Accounts receivable	(6,000)
Supplies	2,000	Owner’s drawings	(2,000)
Accounts payable	(8,000)	Notes payable	10,500
	<u>\$28,500</u>		<u>\$28,500</u>

### Instructions

Explain to Sandi Alcon in a memo why the original balance sheet is incorrect, and what should be done to correct it.

### Ethics Case

**CT1.4** After numerous campus interviews, Travis Chase, a senior at Great Northern College, received two office interview invitations from the Baltimore offices of two large firms. Both firms offered to cover his out-of-pocket expenses (travel, hotel, and meals). He scheduled the interviews for both firms on the same day, one in the morning and one in the afternoon. At the conclusion of each interview, he submitted to both firms his total out-of-pocket expenses for the trip to Baltimore: mileage \$112 (280 miles at \$0.40), hotel \$130, meals \$36, and parking and tolls \$18, for a total of \$296. He believes this approach is appropriate. If he had made two trips, his cost would have been two times \$296. He is also certain that neither firm knew he had visited the other on that same trip. Within 10 days, Travis received two checks in the mail, each in the amount of \$296.

#### Instructions

- a. Who are the stakeholders (affected parties) in this situation?
- b. What are the ethical issues in this case?
- c. What would you do in this situation?

### All about You

**CT1.5** Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity to being both unethical and illegal attempts to mislead investors and creditors.

#### Instructions

Provide responses for each of the following questions.

- a. Discuss whether you think each of the following actions (adapted from the FinAid website) to increase the chances of receiving financial aid is ethical.
  1. Spend the student's assets and income first, before spending parents' assets and income.
  2. Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
  3. State that a truly financially dependent child is independent.
  4. Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.
- b. What are some reasons why a **company** might want to overstate its earnings?
- c. What are some reasons why a **company** might want to understate its earnings?
- d. Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?