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# Accounting in Action

The **Chapter Preview** describes the purpose of the chapter and highlights major topics.

## Chapter Preview

The following Feature Story about **Columbia Sportswear Company** highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information. The purpose of this chapter is to show you that accounting is the system used to provide useful financial information.

The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.

## Feature Story

### Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, “If I’m not going to be an accountant, why do I need

to know accounting?” Well, consider this quote from Harold Geneen, the former chairman of **IT&T**: “To be good at your business, you have to know the numbers—cold.” In business, accounting and financial statements are the means for communicating the numbers. If you don’t know how to read financial statements, you can’t really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of **Columbia Sportswear Company**, headquartered in Portland, Oregon. Gert Boyle's family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat Company. In 1971, Gert's husband, who was then running the company, died suddenly of a heart attack. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of \$1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail.

Columbia doesn't just focus on financial success. Several of its factories have participated in a project to increase health

awareness of female factory workers in developing countries. Columbia is also a founding member of the Sustainable Apparel Coalition, which strives to reduce the environmental and social impact of the apparel industry. In addition, the company monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address such issues as forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

Employers such as Columbia Sportswear generally assume that managers in all areas of the company are "financially literate." To help prepare you for that, this text will help you learn how to read and prepare financial statements, and how to use key tools to evaluate financial results using basic data analytics.

The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.

## Chapter Outline

### LEARNING OBJECTIVES

### REVIEW

### PRACTICE

<b>LO 1</b> Identify the activities and users associated with accounting.	<ul style="list-style-type: none"> <li>• Three activities</li> <li>• Who uses accounting data</li> </ul>	<b>DO IT! 1</b> Basic Concepts
<b>LO 2</b> Explain the building blocks of accounting: ethics, principles, and assumptions.	<ul style="list-style-type: none"> <li>• Ethics</li> <li>• GAAP</li> <li>• Measurement principles</li> <li>• Assumptions</li> </ul>	<b>DO IT! 2</b> Building Blocks of Accounting
<b>LO 3</b> State the accounting equation, and define its components.	<ul style="list-style-type: none"> <li>• Assets</li> <li>• Liabilities</li> <li>• Stockholders' equity</li> </ul>	<b>DO IT! 3</b> Stockholders' Equity Effects
<b>LO 4</b> Analyze the effects of business transactions on the accounting equation.	<ul style="list-style-type: none"> <li>• Accounting transactions</li> <li>• Transaction analysis</li> <li>• Summary of transactions</li> </ul>	<b>DO IT! 4</b> Tabular Analysis
<b>LO 5</b> Describe the four financial statements and how they are prepared.	<ul style="list-style-type: none"> <li>• Income statement</li> <li>• Retained earnings statement</li> <li>• Balance sheet</li> <li>• Statement of cash flows</li> </ul>	<b>DO IT! 5</b> Financial Statement Items

**Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.**

**Visit WileyPLUS for additional tutorials and practice opportunities.**

# Accounting Activities and Users

## LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by **Nike** founder Phil Knight, **Home Depot** co-founder Arthur Blank, former acting director of the **Federal Bureau of Investigation (FBI)** Thomas Pickard, and numerous members of Congress? Accounting.<sup>1</sup> Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

**Accounting** consists of three basic activities—it **identifies, records, and communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

**Essential terms** are printed in blue when they first appear, and are defined in the end-of-chapter **Glossary Review**.

## Three Activities

As a starting point to the accounting process, a company **identifies the economic events relevant to its business**. Examples of economic events are the sale of snack chips by **PepsiCo**, the provision of telephone services by **AT&T**, and the payment of wages by **Facebook**.

Once a company like PepsiCo identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic, chronological diary of events**, measured in dollars and cents. In recording, PepsiCo also classifies and summarizes economic events.

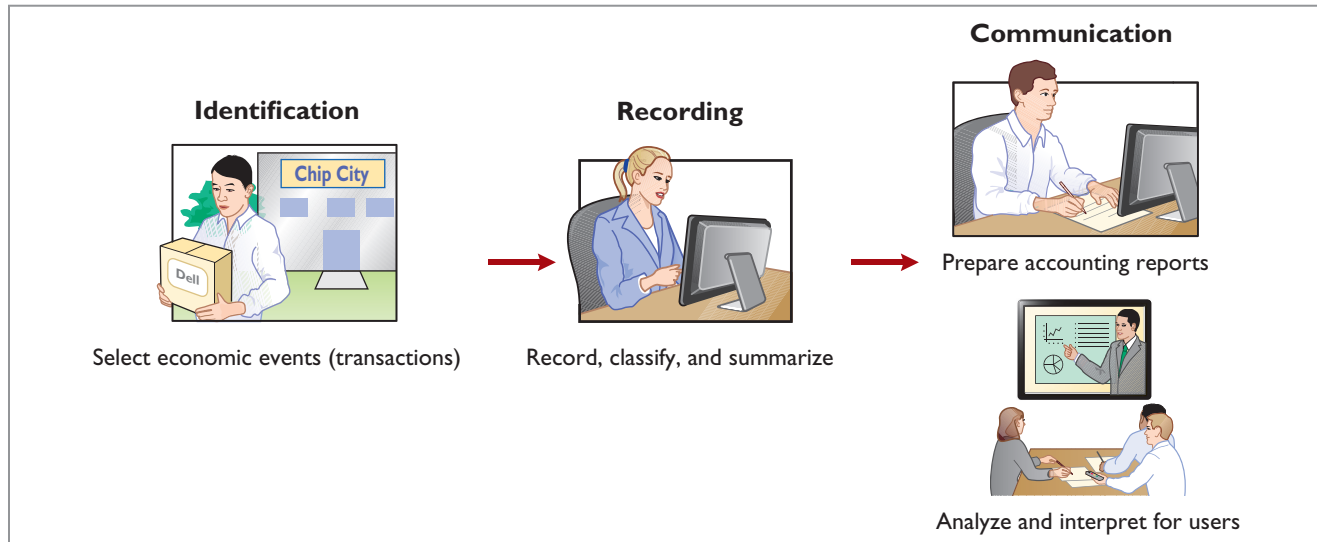
Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, PepsiCo reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, PepsiCo accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses, meaning, and limitations of reported data**. Appendices A–E show the financial statements of **Apple Inc.**, **PepsiCo, Inc.**, **The Coca-Cola Company**, **Amazon.com, Inc.**, and **Walmart Inc.**, respectively. (In addition, in the *A Look at IFRS* section at the end of each chapter, the French company **LVMH—Louis Vuitton** is analyzed.) We refer to these statements at various places throughout the text. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

<sup>1</sup>The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

**Illustration 1.1** summarizes the activities of the accounting process.

**ILLUSTRATION 1.1** The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**<sup>2</sup>

#### HELPFUL HINT

Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.

**Helpful Hints** further clarify concepts being discussed.

## Who Uses Accounting Data

Accounting software systems collect vast amounts of data about the economic events experienced by a company and about the parties with whom the company engages, such as suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to make more informed business decisions. **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences. As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see **Helpful Hint**).

**Users** of accounting information can be divided broadly into two groups: internal users and external users.

### Internal Users

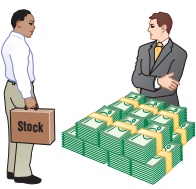
**Internal users** of accounting information are the managers who plan, organize, and run a business. These include **marketing managers, production supervisors, finance directors, and company officers**. In running a business, internal users must answer many important questions, as shown in **Illustration 1.2**.

To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

<sup>2</sup>The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. 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.


**ILLUSTRATION 1.2** Questions that internal users ask

**Questions Asked by Internal Users**




**Finance**

Is cash sufficient to pay dividends to **Microsoft** stockholders?



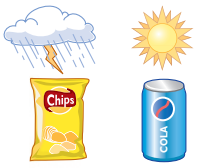
**Marketing**

What price should **Apple** charge for an iPhone to maximize the company's net income?



**Human Resources**

Can **General Motors** afford to give its employees pay raises this year?



**Management**

Which **PepsiCo** product line is the most profitable? Should any product lines be eliminated?

**Accounting Across the Organization** boxes demonstrate applications of accounting information in various business functions.

## Accounting Across the Organization Clif Bar & Company



iStock.com/Dan Moore

### Owning a Piece of the Bar

The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has approximately 1,000 employees and was named one of the leading Landor's Breakaway Brands®. One of **Clif Bar & Company's** proudest moments was the creation of an employee stock

ownership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company. The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with basic accounting knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.


**What are the benefits to the company and to the employees of making the financial statements available to all employees? (Answer is available near the end of the chapter.)**

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

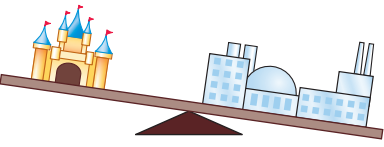
**ILLUSTRATION 1.3** Questions that external users ask

**Questions Asked by External Users**




**Investors**

Is **General Electric** earning satisfactory income?



**Investors**

How does **Disney** compare in size and profitability with **WarnerMedia**?



**Creditors**

Will **United Airlines** be able to pay its debts as they come due?

**Financial accounting** answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with tax laws. **Customers** are interested in whether a company like **Tesla, Inc.** will continue to honor product warranties and support its product lines. **Labor unions**, such as the **Major League Baseball Players Association**, want to know whether the owners have the ability to pay increased wages and benefits.

**Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules.

### ACTION PLAN

- Review the basic concepts discussed.
- Develop an understanding of the key terms used.

The **DO IT!** exercises ask you to put newly acquired knowledge to work. They outline the **Action Plan** necessary to complete the exercise, and they show a **Solution**.

### DO IT! 1 | Basic Concepts

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

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.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

### Solution

1. True. 2. False. Bookkeeping involves only the recording step. 3. False. Accountants analyze and interpret information in reports as part of the communication step. 4. False. The two most common types of external users are investors and creditors. 5. True.

Related exercise material: **DO IT! 1.1, E1.1, and E1.2.**

## The Building Blocks of Accounting

### LEARNING OBJECTIVE 2

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

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting 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

People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the stock market if they think share prices are rigged. At one time, the financial press was full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG**. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing.

One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. 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 (see **Ethics Note**).

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this text:

1. A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *People, Planet, and Profit Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.


When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in **Illustration 1.4**.

**Ethics Notes** help sensitize you to some of the ethical issues in accounting.

#### ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, “Trust everyone, but cut the deck.” What Sarbanes-Oxley does is to provide measures (like cutting the deck of playing cards) that help ensure that fraud will not occur.

#### ILLUSTRATION 1.4 Steps in analyzing ethics cases and situations



<p><b>1. Recognize an ethical situation and the ethical issues involved.</b></p> <p>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></p> <p>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></p> <p>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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**Insight** boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers to the critical thinking questions as well as additional questions are available in WileyPLUS.

### Ethics Insight Dewey & LeBoeuf LLP



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#### I Felt the Pressure—Would You?

“I felt the pressure.” That’s what some of the employees of the now-defunct law firm of **Dewey & LeBoeuf LLP** indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- “I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate.”
- “I intentionally gave the auditors incorrect information in the course of the audit.”

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern about unethical practices as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

**Sources:** Ashby Jones, “Guilty Pleas of Dewey Staff Detail the Alleged Fraud,” *Wall Street Journal* (March 28, 2014); and Sara Randazzo, “Dewey CFO Escapes Jail Time in Fraud Case Sentencing,” *Wall Street Journal* (October 10, 2017).

**Why did these employees lie, and what do you believe should be their penalty for these lies? (Answer is available near the end of the chapter.)**

## Generally Accepted Accounting Principles

### International Note

Over 115 countries use international standards (called IFRS). For example, all companies in the European Union follow IFRS. The differences between U.S. and international standards are not generally significant.

**International Notes** highlight differences between U.S. and international accounting standards.

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. 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 relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)** (see **International Note**).

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, the two standard-setting bodies have made efforts to reduce the differences between U.S. GAAP and IFRS. However, it seems likely that there will continue to be two sets of financial reporting standards in the world for the foreseeable future due to both the FASB and the IASB taking different approaches to various financial reporting issues. We highlight any major differences between GAAP and IFRS in *International Notes* as part of the text discussion as well as provide a more in-depth analysis in the *A Look at IFRS* section at the end of each chapter.

### International Insight



Toru Hanai/Pool/Getty Images

#### The Korean Discount

If you think that accounting standards don't matter, consider recent events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting

practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards.

This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, and Japan, have also decided either to adopt international standards or to create standards that are based on the international standards.

**Source:** Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

**What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? (Answer is available near the end of the chapter.)**

#### HELPFUL HINT

*Relevance and faithful representation are two primary qualities that make accounting information useful for decision-making.*

## Measurement Principles

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 (see **Helpful Hint**). **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. This is true not only at the time the asset is purchased but also over the time the asset is held. For example, if **Best Buy** purchases land for \$360,000, the company initially reports it in its accounting records at \$360,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to \$400,000? Under the historical cost principle, it continues to report the land at \$360,000.

## Fair Value Principle

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). Fair value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at fair value because market price information is usually readily available for these types of assets.

In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

## Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

### 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 accounting to quantify (measure) economic events. The monetary unit assumption is vital to applying the historical cost principle.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in monetary terms. Though this information is important, companies record only events that can be measured in money.

### Economic Entity Assumption

**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 (Southern Baptist). 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 (see **Ethics Note**). To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of her business. Similarly, **J. Crew** and **Gap Inc.** are segregated into separate economic entities for accounting purposes.

**Proprietorship** A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

#### ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving **Adelphia**. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over \$2 billion of loans to the founding family.

**Partnership** A business owned by two or more persons associated as partners is a **partnership**. In most respects, a partnership is like a proprietorship except that more than one owner is involved. Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants).

**Corporation** A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is a **corporation**. The holders of the shares (stockholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Stockholders **may transfer all or part of their ownership shares to other investors at any time** (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life**.

Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest companies in the United States—for example, **ExxonMobil, Ford, Walmart Inc., Citigroup, and Apple**—are corporations.

## Accounting Across the Organization



blublaf/E+/Getty Images

### Spinning the Career Wheel

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include:

**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 wise business decisions.

**Marketing:** Marketing specialists at **Procter & Gamble** must be sensitive to costs and benefits, which accounting helps them

quantify and understand. Making a sale is meaningless unless it is a profitable sale.

**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?

**How might accounting help you? (Answer is available near the end of the chapter.)**

### ACTION PLAN

- Review the discussion of ethics and financial reporting standards.
- Develop an understanding of the key terms used.

### DO IT! 2 | Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. Congress passed the Sarbanes-Oxley Act to reduce unethical behavior and decrease the likelihood of future corporate scandals.
2. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).

3. The historical cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if its fair value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. 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. False. The historical cost principle dictates that companies record assets at their cost. Under the historical cost principle, the company must also use cost in later periods.
4. False. Faithful representation, not relevance, means that financial information matches what really happened; the information is factual. 5. True.

Related exercise material: **DO IT! 1.2, E1.3, and E1.4.**

## The Accounting Equation

### LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **Google** has total assets of approximately \$93.8 billion. Liabilities and stockholders' equity are the rights or claims against these resources. Thus, Google has \$93.8 billion of claims against its \$93.8 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **stockholders' equity**. Google has liabilities of \$22.1 billion and stockholders' equity of \$71.7 billion.

We can express the relationship of assets, liabilities, and stockholders' equity as an equation, as shown in **Illustration 1.5**.

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

### ILLUSTRATION 1.5

The basic accounting equation

This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and stockholders' equity. Liabilities appear before stockholders' equity in the basic accounting equation because they are paid first if a business is liquidated.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as **PepsiCo**. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

## Assets

As noted above, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, consider Campus Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza include tables, chairs, jukebox, cash register, oven, tableware, and, of course, cash.

## Liabilities

**Liabilities** are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Campus Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.
- Campus Pizza also has a **note payable** to First National Bank for the money borrowed to purchase the delivery truck.
- Campus Pizza may also have **salaries and wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Campus Pizza owes money are its **creditors**.

Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

## Stockholders' Equity

The ownership claim on a corporation's total assets is **stockholders' equity** (see **Helpful Hint**). It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or stockholders. To find out what belongs to stockholders, we subtract creditors' claims (the liabilities) from the assets. The remainder is the stockholders' claim on the assets—stockholders' equity. It is often referred to as **residual equity**—that is, the equity “left over” after creditors' claims are satisfied.

The stockholders' equity section of a corporation's balance sheet generally consists of (1) common stock and (2) retained earnings.

### Common Stock

A corporation may obtain funds by selling shares of stock to investors. **Common stock** is the term used to describe the total amount paid in by stockholders for the shares they purchase.

### Retained Earnings

The **retained earnings** section of the balance sheet is determined by three items: revenues, expenses, and dividends.

**Revenues** **Revenues are the increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business** (see **Helpful Hint**). Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Campus Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales. Other titles for and sources of revenue common to many businesses are sales, fees, services, commissions, interest, dividends, royalties, and rent.

**Expenses** **Expenses are the cost of assets consumed or services used in the process of generating revenue. They are decreases in stockholders' equity that result from operating the business** (see **Helpful Hint**). Like revenues, expenses take many forms and are called various names depending on the type of asset consumed or service used. For example, Campus Pizza recognizes the following types of expenses: cost of ingredients (flour, cheese, tomato paste, meat, mushrooms, etc.); cost of beverages; wages expense; utilities expense (electric, gas, and water expense); telephone expense; delivery expense (gasoline, repairs, licenses, etc.); supplies expense (napkins, detergents, aprons, etc.); rent expense; interest expense; and property tax expense.

**Dividends** Net income represents an increase in net assets which are then available to distribute to stockholders. The distribution of cash or other assets to stockholders is called a **dividend**. Dividends reduce retained earnings. However, dividends are **not an expense**.

#### HELPFUL HINT

In some situations, accountants use the term *owner's equity* and in others *owners' equity*. *Owner's* refers to one owner (the case with a sole proprietorship), and *owners'* refers to multiple owners (the case with partnerships). The term *stockholders' equity* refers to ownership in corporations.

#### HELPFUL HINT

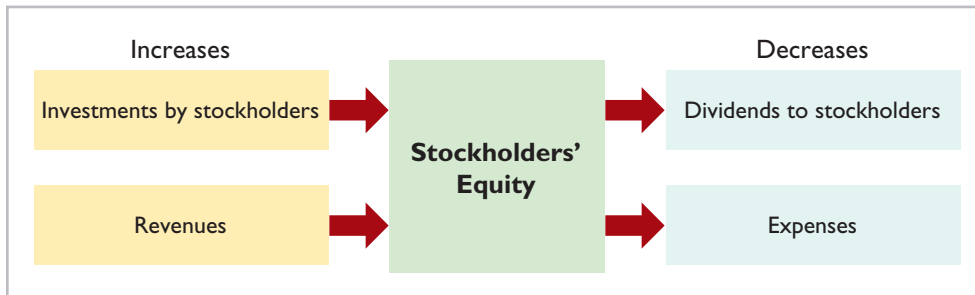
The effect of revenues is positive—an increase in stockholders' equity coupled with an increase in assets or a decrease in liabilities.

#### HELPFUL HINT

The effect of expenses is negative—a decrease in stockholders' equity coupled with a decrease in assets or an increase in liabilities.

A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the stockholders).

In summary, the principal sources (increases) of stockholders' equity are investments by stockholders and revenues from business operations. In contrast, reductions (decreases) in stockholders' equity result from expenses and dividends. These relationships are shown in **Illustration 1.6**.

**ILLUSTRATION 1.6**

**Increases and decreases in stockholders' equity**

### DO IT! 3 | Stockholders' Equity Effects

Classify the following items as issuance of stock (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases stockholders' equity.

- |                     |                                |
|---------------------|--------------------------------|
| 1. Rent Expense.    | 3. Dividends.                  |
| 2. Service Revenue. | 4. Salaries and Wages Expense. |

#### Solution

1. Rent Expense is an expense (E); it decreases stockholders' equity. 2. Service Revenue is revenue (R); it increases stockholders' equity. 3. Dividends is a distribution to stockholders (D); it decreases stockholders' equity. 4. Salaries and Wages Expense is an expense (E); it decreases stockholders' equity.

Related exercise material: **BE1.1, BE1.2, BE1.3, BE1.4, BE1.5, DO IT! 1.3, and E1.5.**

#### ACTION PLAN

- Understand the sources of revenue.
- Understand what causes expenses.
- Review the rules for changes in stockholders' equity.
- Recognize that dividends are distributions of cash or other assets to stockholders.

## Analyzing Business Transactions

### LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.



The system of collecting and processing transaction data and communicating financial information to decision-makers is known as the **accounting information system**. Factors that shape an accounting information system include the nature of the company's business,

This **accounting cycle graphic** illustrates the steps companies follow each period to record transactions and eventually prepare financial statements.

the types of transactions, the size of the company, the volume of data, and the information demands of management and others.

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** stated, “We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area.” In addition, many companies have upgraded their accounting information systems in response to the requirements of Sarbanes-Oxley.

Accounting information systems rely on a process referred to as **the accounting cycle**. As you can see from the graphic at the beginning of this section, the accounting cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. We explain each of the steps, starting in this chapter and continuing in Chapters 2–4.

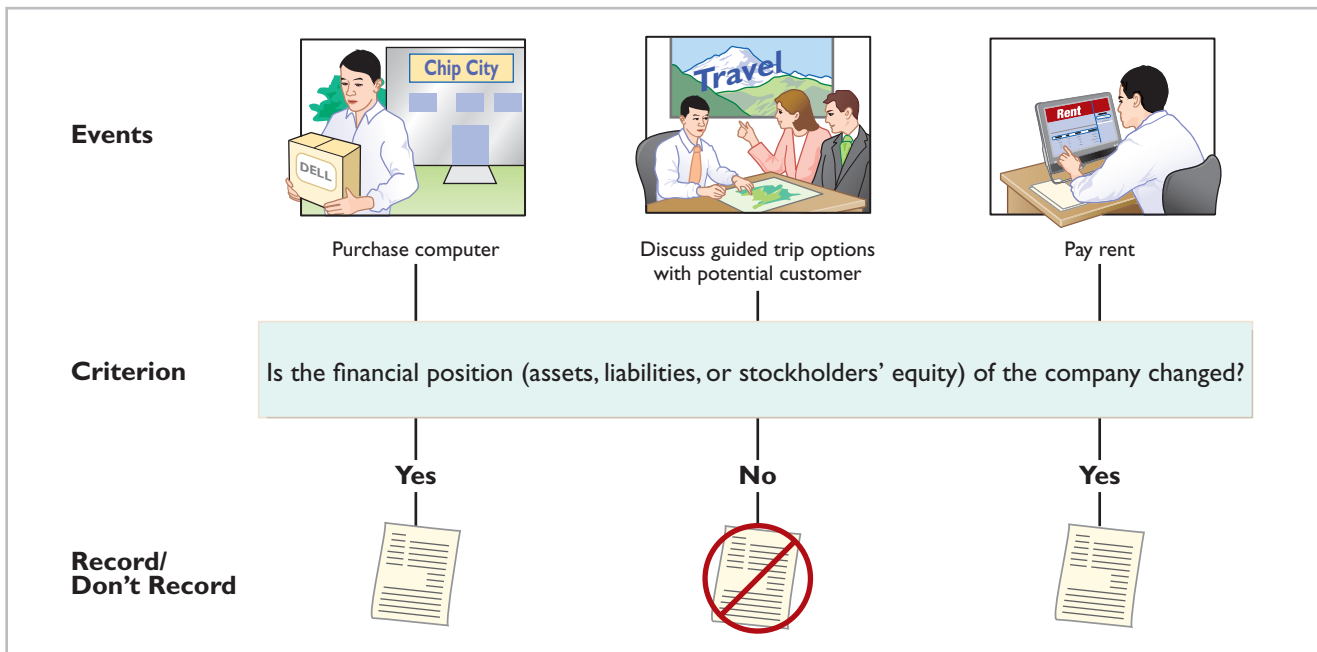
In this text, in order to emphasize the underlying concepts and principles, we focus on a manual accounting system. The accounting concepts and principles do not change whether a system is computerized or manual.

## Accounting Transactions

**Transactions (business transactions)** are a business’s economic events recorded by accountants. Transactions may be external or internal. **External transactions** involve economic events between the company and some outside enterprise. For example, Campus Pizza’s purchase of cooking equipment from a supplier, payment of monthly rent to the landlord, and sale of pizzas to customers are external transactions. **Internal transactions** are economic events that occur entirely within one company. The use of cooking and cleaning supplies are internal transactions for Campus Pizza.

Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. **Illustration 1.7** demonstrates the transaction identification process.

**ILLUSTRATION 1.7** Transaction identification process



Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding:

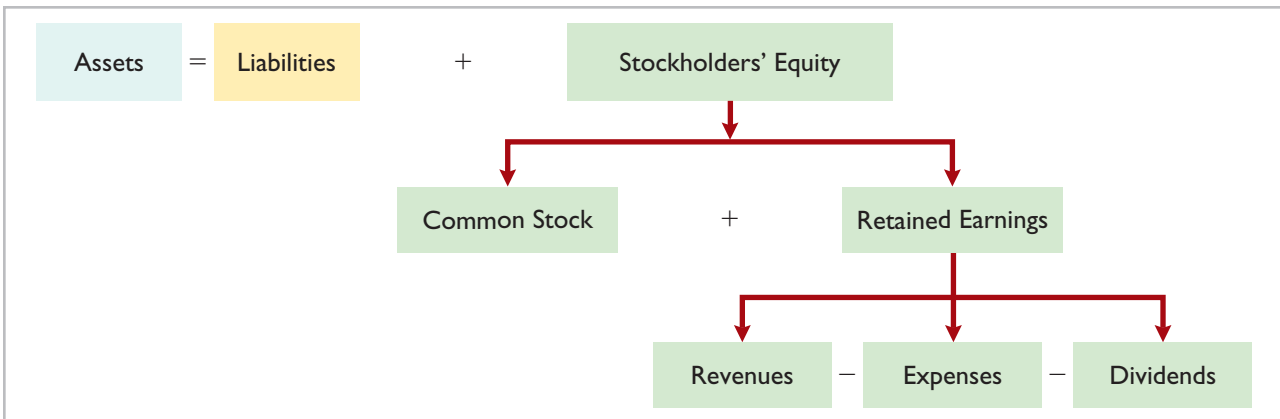
- Decrease in another asset, *or*
- Increase in a specific liability, *or*
- Increase in stockholders' equity.

Two or more items could be affected. For example, as one asset is increased \$10,000, another asset could decrease \$6,000 and a liability could increase \$4,000. Any change in a liability or ownership claim is subject to similar analysis.

## Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte Inc., a smartphone app development business, during its first month of operations. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on stockholders' equity. Recall that stockholders' equity is comprised of two parts: common stock and retained earnings. Common stock is affected when the company issues new shares of stock in exchange for cash. Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends. **Illustration 1.8** shows the **expanded accounting equation**.

**ILLUSTRATION 1.8** Expanded accounting equation



If you are tempted to skip ahead after you've read a few of the following transaction analyses, don't do it (see **Helpful Hint**). Each has something unique to teach, something you'll need later. (We assure you that we've kept them to the minimum needed!)

**Transaction 1. Investment of Cash by Stockholders** Ray and Barbara Neal start a smartphone app development company that they incorporate as Softbyte Inc. On September 1, 2020, they invest \$15,000 cash in the business in exchange for \$15,000 of common stock. The common stock indicates the ownership interest that the Neals have in Softbyte Inc. This transaction results in an equal increase in both assets and stockholders' equity.

**HELPFUL HINT**  
Study these transactions until you are sure you understand them. They are not difficult, but understanding them is important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential in accounting.

Basic Analysis	The asset Cash increases \$15,000, and stockholders' equity (specifically, Common Stock) increases \$15,000.
----------------	--------------------------------------------------------------------------------------------------------------

Equation Analysis	$\begin{array}{r} \text{Assets} \\ \hline \text{Cash} \\ \hline (1) \quad +\$15,000 \end{array} = \begin{array}{r} \text{Liabilities} \\ \hline \end{array} + \begin{array}{r} \text{Stockholders' Equity} \\ \hline \text{Common Stock} \\ \hline +\$15,000 \end{array} \quad \text{Issued Stock}$
-------------------	-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in stockholders' equity (in this case, issued stock) is indicated. Why does this matter? Because investments by stockholders do not represent revenues, and they are excluded in determining net income. Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations. Additional investments (i.e., investments made by stockholders after the corporation has been initially formed) have the same effect on stockholders' equity as the initial investment.

**Transaction 2. Purchase of Equipment for Cash** Softbyte Inc. purchases computer equipment for \$7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.

**Basic Analysis** The asset Cash decreases \$7,000, and the asset Equipment increases \$7,000.

<b>Equation Analysis</b>		<b>Assets</b>		=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>
		Cash	+	Equipment	=		Common Stock
		\$15,000					\$15,000
	(2)	-7,000		+7,000			
		\$ 8,000	+	\$7,000	=		\$15,000
	\$15,000						

Observe that total assets are still \$15,000. Common stock also remains at \$15,000, the amount of the original investment.

**Transaction 3. Purchase of Supplies on Credit** Softbyte Inc. purchases headsets (and other computer accessories expected to last several months) for \$1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October. This transaction is a purchase on account (a credit purchase). Assets increase because of the expected future benefits of using the headsets and computer accessories, and liabilities increase by the amount due Mobile Solutions.

**Basic Analysis** The asset Supplies increases \$1,600, and the liability Accounts Payable increases \$1,600.

<b>Equation Analysis</b>		<b>Assets</b>			=	<b>Liabilities</b>	+	<b>Stockholders' Equity</b>			
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	
		\$8,000				\$7,000			\$15,000		
	(3)			+1,600			+1,600				
		\$8,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	
	\$16,600						\$16,600				

Total assets are now \$16,600. This total is matched by a \$1,600 creditor's claim and a \$15,000 ownership claim.

**Transaction 4. Services Performed for Cash** Softbyte Inc. receives \$1,200 cash from customers for app development services it has performed. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases stockholders' equity**.

Basic  
Analysis

The asset Cash increases \$1,200, and stockholders' equity increases \$1,200 due to Service Revenue.

Equation  
Analysis

	Assets			=	Liabilities	+	Stockholders' Equity			
	Cash	+ Supplies	+ Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings		
								+ Rev.	- Exp.	- Div.
	\$8,000	\$1,600	\$7,000	=	\$1,600	+	\$15,000			
(4)	<b>+1,200</b>			=		+		<b>+1,200</b>		
	\$9,200	+ \$1,600	+ \$7,000	=	\$1,600	+	\$15,000	+ \$1,200		
	\$17,800				\$17,800					

**Service  
Revenue**

The two sides of the equation balance at \$17,800. Service Revenue is included in determining Softbyte's net income.

Note that we do not have room to give details for each individual revenue and expense account in this illustration. Thus, revenues (and expenses when we get to them) are summarized under one column heading for Revenues and one for Expenses. However, it is important to keep track of the category (account) titles affected (e.g., Service Revenue) as they will be needed when we prepare financial statements later in the chapter.

**Transaction 5. Purchase of Advertising on Credit** Softbyte Inc. receives a bill for \$250 from the *Daily News* for advertising on its online website but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in stockholders' equity.

Basic  
Analysis

The liability Accounts Payable increases \$250, and stockholders' equity decreases \$250 due to Advertising Expense.

Equation  
Analysis

	Assets			=	Liabilities	+	Stockholders' Equity			
	Cash	+ Supplies	+ Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings		
								+ Rev.	- Exp.	- Div.
	\$9,200	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$1,200		
(5)				=	<b>+250</b>	+			<b>-\$250</b>	
	\$9,200	+ \$1,600	+ \$7,000	=	\$1,850	+	\$15,000	+ \$1,200	- \$250	
	\$17,800				\$17,800					

**Advertising  
Expense**

The two sides of the equation still balance at \$17,800. Retained Earnings decreases when Softbyte incurs the expense. Expenses do not have to be paid in cash at the time they are incurred. When Softbyte pays at a later date, the liability Accounts Payable will decrease and the asset Cash will decrease (see Transaction 8). The cost of advertising is an expense (rather than an asset) because Softbyte has used the benefits. Advertising Expense is included in determining net income.

**Transaction 6. Services Performed for Cash and Credit** Softbyte Inc. performs \$3,500 of app development services for customers. The company receives cash of \$1,500 from customers, and it bills the balance of \$2,000 on account. This transaction results in an equal increase in assets and stockholders' equity.

Basic  
Analysis

Three specific items are affected: The asset Cash increases \$1,500, the asset Accounts Receivable increases \$2,000, and stockholders' equity increases \$3,500 due to Service Revenue.

Equation  
Analysis

Assets				=	Liabilities	+	Stockholders' Equity			
Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings		
								Rev.	- Exp.	- Div.
\$ 9,200		\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$1,200	\$250	
(6) <b>+1,500</b>	<b>+2,000</b>							<b>+3,500</b>		<b>Service Revenue</b>
\$10,700	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,850	+	\$15,000	+ \$4,700	- \$250	
\$21,300					\$21,300					

Softbyte recognizes \$3,500 in revenues when it performs the service. In exchange for this service, it received \$1,500 in Cash and Accounts Receivable of \$2,000. This Accounts Receivable represents customers' promises to pay \$2,000 to Softbyte in the future. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable (see Transaction 9).

**Transaction 7. Payment of Expenses** Softbyte Inc. pays the following expenses in cash for September: office rent \$600, salaries and wages of employees \$900, and utilities \$200. These payments result in an equal decrease in assets and stockholders' equity.

Basic  
Analysis

The asset Cash decreases \$1,700, and stockholders' equity decreases \$1,700 due to the following expenses: Rent Expense, Salaries and Wages Expense, and Utilities Expense.

Equation  
Analysis

Assets				=	Liabilities	-	Stockholders' Equity			
Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings		
								Rev.	- Exp.	- Div.
\$10,700	\$2,000	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$4,700	\$250	
(7) <b>-1,700</b>									<b>-600</b>	<b>Rent Exp.</b>
									<b>-900</b>	<b>Sal./Wages Exp.</b>
									<b>-200</b>	<b>Utilities Exp.</b>
\$ 9,000	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,850	+	\$15,000	+ \$4,700	- \$1,950	
\$19,600					\$19,600					

The two sides of the equation now balance at \$19,600. Three lines are required in the analysis to indicate the different types of expenses that have been incurred.

**Transaction 8. Payment of Accounts Payable** Softbyte Inc. pays its \$250 *Daily News* bill in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable and a decrease in stockholders' equity.

Basic  
Analysis

This cash payment "on account" decreases the asset Cash by \$250 and also decreases the liability Accounts Payable by \$250.

Equation  
Analysis

Assets				=	Liabilities	+	Stockholders' Equity			
Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings		
								Rev.	- Exp.	- Div.
\$9,000	\$2,000	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$4,700	\$1,950	
(8) <b>-250</b>					<b>-250</b>					
\$8,750	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,600	+	\$15,000	+ \$4,700	- \$1,950	
\$19,350					\$19,350					

Observe that the payment of a liability related to an expense that has previously been recorded does not affect stockholders' equity. Softbyte recorded the expense (in Transaction 5) and should not record it again.

**Transaction 9. Receipt of Cash on Account** Softbyte Inc. receives \$600 in cash from customers who had been billed for services (in Transaction 6). Transaction 9 does not change total assets, but it changes the composition of those assets.

Basic  
Analysis

The asset Cash increases \$600, and the asset Accounts Receivable decreases \$600.

Equation  
Analysis

Assets				=	Liabilities		+	Stockholders' Equity								
Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings				
												Rev.	-	Exp.	-	Div.
\$8,750		\$2,000		\$1,600		\$7,000		\$1,600		\$15,000		\$4,700		\$1,950		
(9) <span style="color: red;">+600</span>		<span style="color: red;">-600</span>														
\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950	-	
\$19,350						\$19,350										

Note that the collection of an account receivable for services previously billed and recorded does not affect stockholders' equity. Softbyte already recorded this revenue (in Transaction 6) and should not record it again.

**Transaction 10. Dividends** The corporation pays a dividend of \$1,300 in cash to Ray and Barbara Neal, the stockholders of Softbyte Inc. This transaction results in an equal decrease in assets and stockholders' equity.

Basic  
Analysis

The asset Cash decreases \$1,300, and stockholders' equity decreases \$1,300 due to dividends.

Equation  
Analysis

Assets				=	Liabilities		+	Stockholders' Equity								
Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings				
												Rev.	-	Exp.	-	Div.
\$9,350		\$1,400		\$1,600		\$7,000		\$1,600		\$15,000		\$4,700		\$1,950		
(10) <span style="color: red;">-1,300</span>																<span style="color: red;">-1,300</span> Dividends
\$8,050	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950	-	\$1,300
\$18,050						\$18,050										

Note that the dividend reduces retained earnings, which is part of stockholders' equity. **Dividends are not expenses.** Like stockholders' investments, dividends are excluded in determining net income.

## Summary of Transactions

**Illustration 1.9** summarizes the September transactions of Softbyte Inc. to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction. Finally, Illustration 1.9 demonstrates a number of significant facts:

1. Each transaction must be analyzed in terms of its effect on:
  - a. The three components of the basic accounting equation (assets, liabilities, and stockholders' equity).
  - b. Specific types (kinds) of items within each component (such as the asset Cash).

- The two sides of the equation must always be equal.
- The Common Stock and Retained Earnings columns indicate the causes of each change in the stockholders' claim on assets.

**ILLUSTRATION 1.9** Tabular summary of Softbyte Inc. transactions

Trans- action	Assets				=	Liabilities	+	Stockholders' Equity										
	Cash	+	Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings							
											Rev.	-	Exp.	-	Div.			
(1)	+\$15,000							+	\$15,000								Issued Stock	
(2)	-7,000				+\$7,000													
(3)				+\$1,600			+\$1,600											
(4)	+1,200										+\$1,200						Service Revenue	
(5)							+250						-\$250				Adver. Expense	
(6)	+1,500		+\$2,000								+\$3,500						Service Revenue	
(7)	-1,700												-600				Rent Expense	
													-900				Sal./Wages Exp.	
													-200				Utilities Expense	
(8)	-250						-250											
(9)	+600		-600															
(10)	-1,300																Dividends	
	<u>\$ 8,050</u>	+	<u>\$1,400</u>	+	<u>\$1,600</u>	+	<u>\$7,000</u>	=	<u>\$1,600</u>	+	<u>\$15,000</u>	+	<u>\$4,700</u>	-	<u>\$1,950</u>	-	<u>\$1,300</u>	
	<b>\$18,050</b>					<b>\$18,050</b>												

There! You made it through transaction analysis. If you feel a bit shaky on any of the transactions, it might be a good idea at this point to get up, take a short break, and come back again for a brief (10- to 15-minute) review of the transactions, to make sure you understand them before you go on to the next section.

**ACTION PLAN**

- Analyze the effects of each transaction on the accounting equation.
- Use appropriate category names (not descriptions).
- Keep the accounting equation in balance.

**DO IT! 4 | Tabular Analysis**

Transactions made by Virmari & Co., a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1.9.

- Virmari sold shares of common stock for \$25,000 cash.
- The company purchased \$7,000 of office equipment on credit.
- The company received \$8,000 cash in exchange for services performed.
- The company paid \$850 for this month's rent.
- The company paid a dividend of \$1,000 in cash to stockholders.

**Solution**

Trans- action	Assets			=	Liabilities	+	Stockholders' Equity									
	Cash	+	Equipment	=	Accounts Payable	+	Common Stock	+	Retained Earnings							
									Rev.	-	Exp.	-	Div.			
(1)	+\$25,000						+	\$25,000								
(2)			+\$7,000		+\$7,000											
(3)	+8,000								+\$8,000							Service Revenue
(4)	-850										-\$850					Rent Expense
(5)	-1,000													-\$1,000		Dividends
	<u>\$31,150</u>	+	<u>\$7,000</u>	=	<u>\$7,000</u>	+	<u>\$25,000</u>	+	<u>\$8,000</u>	-	<u>\$850</u>	-	<u>\$1,000</u>			
	<b>\$38,150</b>				<b>\$38,150</b>											

Related exercise material: BE1.6, BE1.7, BE1.8, BE1.9, DO IT! 1.4, E1.6, E1.7, and E1.8.

# The Financial Statements

## LEARNING OBJECTIVE 5

Describe the four financial statements and how they are prepared.

Companies prepare four financial statements from the summarized accounting data (see **Helpful Hint**):

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

These statements provide relevant financial data for internal and external users. **Illustration 1.10** shows the financial statements of Softbyte Inc. Note that the statements shown in Illustration 1.10 are interrelated:

1. Net income of \$2,750 on the **income statement** is added to the beginning balance of retained earnings in the **retained earnings statement**.
2. Retained earnings of \$1,450 at the end of the reporting period shown in the **retained earnings statement** is reported on the **balance sheet**.
3. Cash of \$8,050 on the **balance sheet** is reported on the **statement of cash flows**.

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

Be sure to carefully examine the format and content of each statement in Illustration 1.10. We describe the essential features of each in the following sections (see **International Note**).

## Income Statement

The income statement reports the success or profitability of the company's operations over a specific period of time (see **Alternative Terminology**). For example, Softbyte Inc.'s income statement is dated "For the Month Ended September 30, 2022." It is prepared from the data appearing in the revenue and expense columns of Illustration 1.9. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

The income statement lists revenues first, followed by expenses. Finally, the statement shows net income (or net loss). When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

Although practice varies, we have chosen in our illustrations and homework solutions to list expenses in order of magnitude. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does not include investment and dividend transactions between the stockholders and the business in measuring net income. For example, as explained earlier, the cash dividend from Softbyte Inc. was not regarded as a business expense. This type of transaction is considered a reduction of retained earnings, which causes a decrease in stockholders' equity.

### HELPFUL HINT

The income statement, retained earnings statement, and statement of cash flows are all for a period of time, whereas the balance sheet is for a point in time.

### International Note

The primary types of financial statements required by GAAP and IFRS are the same. In practice, some format differences do exist in presentations employed by GAAP companies compared to IFRS companies.

### ALTERNATIVE TERMINOLOGY

The income statement is sometimes referred to as the *statement of operations, earnings statement, or profit and loss statement*.

**Alternative Terminology** notes present synonymous terms that you may come across in practice.

**ILLUSTRATION 1.10**

**Financial statements and their interrelationships**

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

Note that final sums are double-underlined, and negative amounts (in the statement of cash flows) are presented in parentheses.

The arrows in this illustration show the interrelationships of the four financial statements.

1. Net income is computed first and is needed to determine the ending balance in retained earnings.
2. The ending balance in retained earnings is needed in preparing the balance sheet.
3. The cash shown on the balance sheet is needed in preparing the statement of cash flows.

<b>Softbyte Inc.</b>		
<b>Income Statement</b>		
<b>For the Month Ended September 30, 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		1,950
Net income		<u><u>\$2,750</u></u>
<b>Softbyte Inc.</b>		
<b>Retained Earnings Statement</b>		
<b>For the Month Ended September 30, 2022</b>		
Retained earnings, September 1		\$ -0-
Add: Net income		<u>2,750</u>
		2,750
Less: Dividends		<u>1,300</u>
Retained earnings, September 30		<u><u>\$1,450</u></u>
<b>Softbyte Inc.</b>		
<b>Balance Sheet</b>		
<b>September 30, 2022</b>		
<u>Assets</u>		
Cash		<b>\$ 8,050</b>
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u><u>\$18,050</u></u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Accounts payable		\$ 1,600
Stockholders' equity		
Common stock	<b>\$15,000</b>	
Retained earnings	<u>1,450</u>	<u>16,450</u>
Total liabilities and stockholders' equity		<u><u>\$18,050</u></u>
<b>Softbyte Inc.</b>		
<b>Statement of Cash Flows</b>		
<b>For the Month Ended September 30, 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		
Sale of common stock	\$15,000	
Payment of cash dividends	<u>(1,300)</u>	13,700
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>

1

2

3

## Retained Earnings Statement

Softbyte Inc.'s retained earnings statement reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2022"). Data for the preparation of the retained earnings statement come from the retained earnings columns of the tabular summary (Illustration 1.9) and from the income statement (Illustration 1.10).

The first line of the statement shows the beginning retained earnings amount. Then come net income and dividends. The retained earnings ending balance is the final amount on the statement. The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement.

## Balance Sheet

Softbyte Inc.'s balance sheet reports the assets, liabilities, and stockholders' equity at a specific date (September 30, 2022). The company prepares the balance sheet from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1.9).

Observe that the balance sheet lists assets at the top, followed by liabilities and stockholders' equity. Total assets must equal total liabilities and stockholders' equity. Softbyte Inc. reports only one liability, Accounts Payable, on its balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in [Illustration 1.11](#).

	<u>Liabilities</u>	
Notes payable		\$10,000
Accounts payable		63,000
Salaries and wages payable		<u>18,000</u>
<b>Total liabilities</b>		<b>\$91,000</b>

### ILLUSTRATION 1.11

#### Presentation of liabilities

The balance sheet is like a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

## Statement of Cash Flows

The primary purpose of a **statement of cash flows** is to provide financial information about the cash receipts and cash payments of a company for a specific period of time (see [Helpful Hint](#)). To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's **operating, investing, and financing activities**. In addition, the statement shows the net increase or decrease in cash during the period, and the amount of cash at the end of the period.

Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. 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?

As shown in Softbyte Inc.'s statement of cash flows in [Illustration 1.10](#), cash increased \$8,050 during the period. Net cash provided by operating activities increased cash \$1,350 (cash receipts from revenue less cash payments for expenses). Cash flow from investing activities decreased cash \$7,000 (purchase of equipment). Cash flow from financing activities increased cash \$13,700 (sale of common stock less payment of cash dividends). At this time, you need not be concerned with how these amounts are determined. Chapter 12 will examine in detail how the statement is prepared.

### HELPFUL HINT

The statement of cash flows helps users determine if the company generates enough cash from operations to fund its investing activities.

## People, Planet, and Profit Insight



iStock.com/Marek Uliasz

### Beyond Financial Statements

Should we expand our financial statements beyond the income statement, retained earnings statement, balance sheet, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial results, in evaluating a company. The argument is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing stockholders' interests.

to financial results, in evaluating a company. The argument is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing stockholders' interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But, many interesting and useful efforts are underway. Throughout this text, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to stockholders.

**Why might a company's stockholders be interested in its environmental and social performance? (Answer is available near the end of the chapter.)**

### ACTION PLAN

- Remember the basic accounting equation: assets must equal liabilities plus stockholders' equity.
- Review previous financial statements to determine how total assets, net income, and stockholders' equity are computed.

### DO IT! 5 | Financial Statement Items

Presented below is selected information related to Flanagan Corporation at December 31, 2022. Flanagan reports financial information monthly.

Equipment	\$10,000	Utilities Expense	\$ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

- Determine the total assets of Flanagan at December 31, 2022.
- Determine the net income that Flanagan reported for December 2022.
- Determine the stockholders' equity of Flanagan at December 31, 2022.

### Solution

- The total assets are \$27,000, comprised of Cash \$8,000, Accounts Receivable \$9,000, and Equipment \$10,000.
- Net income is \$14,000, computed as follows.

Revenues		
Service revenue		\$36,000
Expenses		
Rent expense	\$11,000	
Salaries and wages expense	7,000	
Utilities expense	<u>4,000</u>	
Total expenses		<u>22,000</u>
Net income		<u>\$14,000</u>

- The ending stockholders' equity of Flanagan Corporation is \$8,500. By rewriting the accounting equation, we can compute stockholders' equity as assets minus liabilities, as follows.

Total assets [as computed in (a)]		\$27,000
Less: Liabilities		
Notes payable	\$16,500	
Accounts payable	<u>2,000</u>	<u>18,500</u>
Stockholders' equity		<u>\$ 8,500</u>

Note that it is not possible to determine the corporation's stockholders' equity in any other way, because the beginning total for stockholders' equity is not provided.

Related exercise material: **BE1.10, BE1.11, DO IT! 1.5, E1.9, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, E1.16, and E1.17.**

## Appendix 1A

# Career Opportunities in Accounting

## LEARNING OBJECTIVE \*6

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice? First, there are a lot of jobs. In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, “accounting is one degree with 360 degrees of opportunity.”

Accounting is also hot because it is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the accounting failures of companies such as **Enron** and **WorldCom**. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society. Finally, the Sarbanes-Oxley Act (SOX) significantly increased the accounting and internal control requirements for corporations. This dramatically increased demand for professionals with accounting training.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

## Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients. A major portion of public accounting involves **auditing**. In auditing, a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company’s results and financial position. Analysts, investors, and creditors rely heavily on these “audit opinions,” which CPAs have the exclusive authority to issue.

**Taxation** is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies such as the Internal Revenue Service.

A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to performing support services for major marketing projects and merger and acquisition activities.

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

## Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Starbucks**, **Google**, or **PepsiCo**. In **private** (or **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. You might also be a member of your company’s internal audit team. In response to SOX, the internal auditors’ job of reviewing the company’s operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

Alternatively, many accountants work for not-for-profit organizations such as the **Red Cross** or the **Bill and Melinda Gates Foundation**, or for museums, libraries, or performing arts organizations.

## 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 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 also a very high demand for accounting educators at public colleges and universities and in state and local governments.

## Forensic Accounting

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

## “Show Me the Money”

How much can a new accountant make? Take a look at the average salaries for college graduates in public and private accounting shown in **Illustration 1A.1**. Keep in mind if you also have a CPA license, you’ll make 10–15% more when you start out.

### ILLUSTRATION 1A.1

Salary estimates for jobs in public and corporate accounting

Employer	Jr. Level (0–3 yrs.)	Sr. Level (4–6 yrs.)
Public accounting (large firm)	\$63,250–\$83,250	\$78,500–\$106,500
Public accounting (medium firm)	\$56,500–\$67,750	\$70,500–\$96,000
Public accounting (small company)	\$51,500–\$60,500	\$63,750–\$81,500
Corporate accounting (large company)	\$53,750–\$69,500	\$68,750–\$87,750

**Illustration 1A.2** lists some examples of upper-level salaries for managers in corporate accounting. Note that geographic region, experience, education, CPA certification, and company size each play a role in determining salary.

### ILLUSTRATION 1A.2

Upper-level management salaries in corporate accounting

Position	Large Company	Small to Medium Company
Chief financial officer	\$207,000–\$465,750	\$105,250–\$208,750
Corporate controller	\$140,000–\$224,750	\$92,000–\$161,250
Tax manager	\$112,000–\$158,250	\$88,000–\$124,750

The **Review and Practice** section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, exercises, and a comprehensive problem. Detailed solutions are also included.

## Review and Practice

### Learning Objectives Review

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

Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users. The major users and uses of accounting are as follows. (a) Management

uses accounting information to plan, organize, and run the business. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, and labor unions.

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

Ethics are the standards of conduct by which actions are judged as right or wrong. Effective financial reporting depends on sound ethical behavior. Generally accepted accounting principles 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. 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.

## 3 State the accounting equation, and define its components.

The basic accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

Assets are resources a business owns. Liabilities are creditorship claims on total assets. Stockholders' equity is the ownership claim on total assets.

## 4 Analyze the effects of business transactions on the accounting equation.

Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be

a corresponding (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in stockholders' equity.

The expanded accounting equation is:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Common Stock} \\ &+ \text{Revenues} - \text{Expenses} - \text{Dividends} \end{aligned}$$

Common stock is affected when the company issues new shares of stock in exchange for cash. Revenues are increases in assets resulting from income-earning activities. Expenses are the costs of assets consumed or services used in the process of earning revenue. Dividends are payments the company makes to its stockholders.

## 5 Describe the four financial statements and how they are prepared.

An income statement presents the revenues and expenses and resulting net income or net loss for a specific period of time. A retained earnings statement summarizes the changes in retained earnings for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders' equity at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

## \*6 Explain the career opportunities in accounting.

Accounting offers many different jobs in fields such as public and private accounting, governmental accounting, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

## Glossary Review

**Accounting** The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 1-3).

**Accounting information system** The system of collecting and processing transaction data and communicating financial information to decision-makers. (p. 1-13).

**Assets** Resources a business owns. (p. 1-11).

**\*Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to how accurately the financial statements present the company's results and financial position. (p. 1-25).

**Balance sheet** A financial statement that reports the assets, liabilities, and stockholders' equity at a specific date. (p. 1-21).

**Basic accounting equation**  $\text{Assets} = \text{Liabilities} + \text{Stockholders' equity}$ . (p. 1-11).

**Bookkeeping** A part of accounting that involves only the recording of economic events. (p. 1-4).

**Common stock** Term used to describe the total amount paid in by stockholders for the shares they purchase. (p. 1-12).

**Corporation** A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock. (p. 1-10).

**Data analytics** The use of software and statistics to draw inferences from data. (p. 1-4).

**Dividend** A distribution by a corporation to its stockholders. (p. 1-12).

**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. 1-9).

**Ethics** The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 1-7).

**Expanded accounting equation**  $\text{Assets} = \text{Liabilities} + \text{Common stock} + \text{Revenues} - \text{Expenses} - \text{Dividends}$ . (p. 1-15).

**Expenses** The cost of assets consumed or services used in the process of generating revenue. (p. 1-12).

**Fair value principle** An accounting principle stating that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). (p. 1-9).

**Faithful representation** Numbers and descriptions match what really existed or happened—they are factual. (p. 1-8).

**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. 1-8).

**\*Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-26).

**Generally accepted accounting principles (GAAP)** Common standards that indicate how to report economic events. (p. 1-8).

**Historical cost principle** An accounting principle that states that companies should record assets at their cost. (p. 1-9).

**Income statement** A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. (p. 1-21).

**International Accounting Standards Board (IASB)** An accounting standard-setting body that issues standards adopted by many countries outside of the United States. (p. 1-8).

**International Financial Reporting Standards (IFRS)** International accounting standards set by the International Accounting Standards Board (IASB). (p. 1-8).

**Liabilities** Creditor claims against total assets. (p. 1-12).

**\*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. 1-25).

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

**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. 1-9).

**Net income** The amount by which revenues exceed expenses. (p. 1-21).

**Net loss** The amount by which expenses exceed revenues. (p. 1-21).

**Partnership** A business owned by two or more persons associated as partners. (p. 1-10).

**\*Private (or 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. 1-25).

**Proprietorship** A business owned by one person. (p. 1-9).

**\*Public accounting** An area of accounting in which the accountant offers expert service to the general public. (p. 1-25).

**Relevance** Financial information that is capable of making a difference in a decision. (p. 1-8).

**Retained earnings statement** A financial statement that summarizes the changes in retained earnings for a specific period of time. (p. 1-21).

**Revenues** The increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business. (p. 1-12).

**Sarbanes-Oxley Act (SOX)** Law passed by Congress intended to reduce unethical corporate behavior. (p. 1-6).

**Securities and Exchange Commission (SEC)** A governmental agency that oversees U.S. financial markets and accounting standard-setting bodies. (p. 1-8).

**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. 1-21).

**Stockholders' equity** The ownership claim on a corporation's total assets. (p. 1-12).

**\*Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-25).

**Transactions** The economic events of a business that are recorded by accountants. (p. 1-14).

## Practice Multiple-Choice Questions

- (LO 1)** Which of the following is **not** a step in the accounting process?
  - Identification.
  - Economic entity.
  - Recording.
  - Communication.
- (LO 1)** Which of the following statements about users of accounting information is **incorrect**?
  - Management is an internal user.
  - Taxing authorities are external users.
  - Present creditors are external users.
  - Regulatory authorities are internal users.
- (LO 2)** The historical cost principle states that:
  - assets should be initially recorded at cost and adjusted when the fair value changes.
  - activities of an entity are to be kept separate and distinct from its owner.
  - assets should be recorded at their cost.
  - only transaction data capable of being expressed in terms of money be included in the accounting records.

- (LO 2)** Which of the following statements about basic assumptions is **correct**?
  - Basic assumptions are the same as accounting principles.
  - The economic entity assumption states that there should be a particular unit of accountability.
  - The monetary unit assumption enables accounting to measure employee morale.
  - Partnerships are not economic entities.
- (LO 2)** The three types of business entities are:
  - proprietorships, small businesses, and partnerships.
  - proprietorships, partnerships, and corporations.
  - proprietorships, partnerships, and large businesses.
  - financial, manufacturing, and service companies.
- (LO 3)** Net income will result during a time period when:
  - assets exceed liabilities.
  - assets exceed revenues.
  - expenses exceed revenues.
  - revenues exceed expenses.

7. (LO 3) As of December 31, 2022, Reed Company has assets of \$3,500 and stockholders' equity of \$1,500. What are the liabilities for Reed Company as of December 31, 2022?
- \$1,500.
  - \$1,000.
  - \$2,500.
  - \$2,000.
8. (LO 4) Performing services on account will have the following effects on the components of the basic accounting equation:
- increase assets and decrease stockholders' equity.
  - increase assets and increase stockholders' equity.
  - increase assets and increase liabilities.
  - increase liabilities and increase stockholders' equity.
9. (LO 4) Which of the following events is **not** recorded in the accounting records?
- Equipment is purchased on account.
  - An employee is terminated.
  - A cash investment is made into the business.
  - The company pays a cash dividend.
10. (LO 4) During 2022, Seisor Company's assets decreased \$50,000 and its liabilities decreased \$90,000. Its stockholders' equity therefore:
- increased \$40,000.
  - decreased \$140,000.
  - decreased \$40,000.
  - increased \$140,000.
11. (LO 4) Payment of an account payable affects the components of the accounting equation in the following way.
- Decreases stockholders' equity and decreases liabilities.
  - Increases assets and decreases liabilities.
  - Decreases assets and increases stockholders' equity.
  - Decreases assets and decreases liabilities.
12. (LO 5) 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 stockholders' equity at a specific date.
  - An income statement presents the revenues, expenses, changes in stockholders' equity, and resulting net income or net loss for a specific period of time.
  - A retained earnings statement summarizes the changes in retained earnings for a specific period of time.
13. (LO 5) On the last day of the period, Alan Cesska Company buys a \$900 machine on credit. This transaction will affect the:
- income statement only.
  - balance sheet only.
  - income statement and retained earnings statement only.
  - income statement, retained earnings statement, and balance sheet.
14. (LO 5) The financial statement that reports assets, liabilities, and stockholders' equity is the:
- income statement.
  - retained earnings statement.
  - balance sheet.
  - statement of cash flows.
- \*15. (LO 6) Services performed by a public accountant include:
- auditing, taxation, and management consulting.
  - auditing, budgeting, and management consulting.
  - auditing, budgeting, and cost accounting.
  - auditing, budgeting, and management consulting.

## Solutions

1. **b.** Economic entity is not one of the steps in the accounting process. The other choices are true because (a) identification is the first step in the accounting process, (c) recording is the second step in the accounting process, and (d) communication is the third and final step in the accounting process.
2. **d.** Regulatory authorities are external, not internal, users of accounting information. The other choices are true statements.
3. **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.
4. **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.
5. **b.** Proprietorships, partnerships, and corporations are the three types of business entities. Choices (a) and (c) are incorrect because small and large businesses only denote the sizes of businesses. Choice (d) is incorrect because financial, manufacturing, and service companies are types of businesses, not business entities.
6. **d.** Net income results when revenues exceed expenses. The other choices are incorrect because (a) assets and liabilities are not used in the computation of net income; (b) revenues, not assets, are included in the computation of net income; and (c) when expenses exceed revenues, a net loss results.
7. **d.** Using a variation of the basic accounting equation, Assets – Stockholders' equity = Liabilities,  $\$3,500 - \$1,500 = \$2,000$ . Therefore, choices (a) \$1,500, (b) \$1,000, and (c) \$2,500 are incorrect.
8. **b.** When services are performed on account, assets are increased and stockholders' equity is increased. The other choices are incorrect because when services are performed on account (a) stockholders' equity is increased, not decreased; (c) liabilities are not

affected; and (d) stockholders' equity is increased and liabilities are not affected.

**9. b.** If an employee is terminated, this represents an activity of a company, not a business transaction. Assets, liabilities, and stockholders' equity are not affected. Thus, there is no effect on the accounting equation. The other choices are incorrect because they are all recorded: (a) when equipment is purchased on account, both assets and liabilities increase; (c) when a cash investment is made into a business, both assets and stockholders' equity increase; and (d) when a dividend is paid, both assets and stockholders' equity decrease.

**10. a.** Using the basic accounting equation,  $\text{Assets} = \text{Liabilities} + \text{Stockholders' equity}$ ,  $-\$50,000 = -\$90,000 + \text{Stockholders' equity}$ , so stockholders' equity increased \$40,000, not (b) decreased \$140,000, (c) decreased \$40,000, or (d) increased \$140,000.

**11. d.** Payment of an account payable results in an equal decrease of assets (cash) and liabilities (accounts payable). The other choices are incorrect because payment of an account payable (a) does not affect stockholders' equity, (b) does not increase assets, and (c) does not affect stockholders' equity.

**12. c.** An income statement represents the revenues, expenses, and resulting net income or net loss for a specific period of time but not the changes in stockholders' equity. The other choices are true statements.

**13. b.** This transaction will cause assets to increase by \$900 and liabilities to increase by \$900. The other choices are incorrect because this transaction (a) will have no effect on the income statement, (c) will have no effect on the income statement or the retained earnings statement, and (d) will affect the balance sheet but not the income statement or the retained earnings statement.

**14. c.** The balance sheet is the statement that reports assets, liabilities and stockholders' equity. The other choices are incorrect because (a) the income statement reports revenues and expenses, (b) the retained earnings statement reports details about stockholders' equity, and (d) the statement of cash flows reports inflows and outflows of cash.

**\*15. 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.

## Practice Brief Exercises

*Use basic accounting equation.*

**1. (LO 3)** At the beginning of the year, Ortiz Company had total assets of \$900,000 and total liabilities of \$440,000. Answer the following questions.

- If total assets decreased \$100,000 during the year and total liabilities increased \$80,000 during the year, what is the amount of stockholders' equity at the end of the year?
- During the year, total liabilities decreased \$100,000, and stockholders' equity increased \$200,000. What is the amount of total assets at the end of the year?
- If total assets increased \$50,000 during the year and stockholders' equity increased \$60,000 during the year, what is the amount of total liabilities at the end of the year?

### Solution

- $(\$900,000 - \$440,000) - \$100,000 - \$80,000 = \$280,000$  stockholders' equity
  - $\$900,000 - \$100,000 + \$200,000 = \$1,000,000$  total assets
  - $\$440,000 - \$60,000 + \$50,000 = \$430,000$  total liabilities

*Determine effect of transactions on basic accounting equation.*

**2. (LO 4)** The following are three business transactions. Create a table with rows (a), (b), and (c), and columns for assets, liabilities, and stockholders' equity. For each column, indicate whether the transactions increased (+), decreased (-), or had no effect (NE) on assets, liabilities, and stockholders' equity.

- Purchased equipment on account.
- Payment of cash dividends.
- Paid expenses in cash.

### Solution

	<u>Assets</u>	<u>Liabilities</u>	<u>Stockholders' Equity</u>
<b>2. a.</b>	+	+	NE
<b>b.</b>	-	NE	-
<b>c.</b>	-	NE	-

*Determine effect of transactions on basic accounting equation.*

**3. (LO 4)** Follow the same format as in **Practice Brief Exercise 2**. Determine the effect on assets, liabilities, and stockholders' equity of the following three transactions.

- Performed accounting services for clients for cash.
- Borrowed cash from a bank on a note payable.
- Paid cash for rent for the month.

## Solution

	<u>Assets</u>	<u>Liabilities</u>	<u>Stockholders' Equity</u>
3. a.	+	NE	+
b.	+	+	NE
c.	-	NE	-

4. (LO 5) Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or retained earnings statement (RES).

*Determine where items appear on financial statements.*

- |                                     |                           |
|-------------------------------------|---------------------------|
| a. ____ Common stock.               | d. ____ Service revenue.  |
| b. ____ Cash.                       | e. ____ Accounts payable. |
| c. ____ Salaries and wages expense. |                           |

## Solution

4. a. BS Common stock.  
 b. BS Cash.  
 c. IS Salaries and wages expense.  
 d. IS Service revenue.  
 e. BS Accounts payable.

5. (LO 5) Presented below in alphabetical order are balance sheet items for Feagler Company at December 31, 2022. Prepare a balance sheet following the format of Illustration 1.10.

*Prepare a balance sheet.*

Accounts receivable	\$12,500
Cash	38,000
Common stock	5,000
Notes payable	40,000
Retained earnings	5,500

## Solution

5.

<b>Feagler Company</b>	
<b>Balance Sheet</b>	
<b>December 31, 2022</b>	
<u>Assets</u>	
Cash	\$38,000
Accounts receivable	<u>12,500</u>
Total assets	<u>\$50,500</u>
<u>Liabilities and Stockholders' Equity</u>	
Liabilities	
Notes payable	<u>\$40,000</u>
Total liabilities	\$40,000
Stockholders' equity	
Common stock	5,000
Retained earnings	<u>5,500</u>
Total liabilities and stockholders' equity	<u>\$50,500</u>

## Practice Exercises

1. (LO 3, 4) Selected transactions for Beale Lawn Care Company are as follows.

*Analyze the effect of transactions.*

- Sold common stock for cash to start business.
- Paid monthly utilities.
- Purchased land on account.

4. Billed customers for services performed.
5. Paid dividends.
6. Received cash from customers billed in (4).
7. Incurred utilities expense on account.
8. Purchased equipment for cash.
9. Received cash from customers when service was performed.

### Instructions

List the numbers of the above transactions and describe the effect of each transaction on assets, liabilities, and stockholders' equity. For example, the first answer is (1) Increase in assets and increase in stockholders' equity.

### Solution

1. 1. Increase in assets and increase in stockholders' equity.  
2. Decrease in assets and decrease in stockholders' equity.  
3. Increase in assets and increase in liabilities.  
4. Increase in assets and increase in stockholders' equity.  
5. Decrease in assets and decrease in stockholders' equity.  
6. Increase in assets and decrease in assets.  
7. Increase in liabilities and decrease in stockholders' equity.  
8. Increase in assets and decrease in assets.  
9. Increase in assets and increase in stockholders' equity.

*Analyze the effect of transactions on assets, liabilities, and stockholders' equity.*

2. (LO 3, 4) Hayes Computer Timeshare Company entered into the following transactions during May 2022.

1. Purchased office equipment for \$10,000 from Office Outfitters on account.
2. Paid \$3,000 cash for May rent on storage space.
3. Received \$12,000 cash from customers for contracts billed in April.
4. Performed services for Bayliss Construction Company for \$4,000 cash.
5. Paid Southern Power Co. \$10,000 cash for energy usage in May.
6. Stockholders invested an additional \$30,000 in the business.
7. Paid Office Outfitters for the equipment purchased in (1) above.
8. Incurred advertising expense for May of \$1,500 on account.

### Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

- a. An increase in assets and a decrease in assets.
- b. An increase in assets and an increase in stockholders' equity.
- c. An increase in assets and an increase in liabilities.
- d. A decrease in assets and a decrease in stockholders' equity.
- e. A decrease in assets and a decrease in liabilities.
- f. An increase in liabilities and a decrease in stockholders' equity.
- g. An increase in stockholders' equity and a decrease in liabilities.

### Solution

- |         |      |      |      |
|---------|------|------|------|
| 2. 1. c | 3. a | 5. d | 7. e |
| 2. d    | 4. b | 6. b | 8. f |

## Practice Problem

**(LO 4, 5)** Legal Services Inc. was incorporated on July 1, 2022. During the first month of operations, the following transactions occurred.

*Prepare a tabular presentation and financial statements.*

1. Legal Services issued common stock in exchange for cash of \$10,000.
2. Paid \$800 for July rent on office space.
3. Purchased office equipment on account \$3,000.
4. Performed legal services for clients for cash \$1,500.
5. Borrowed \$700 cash from a bank on a note payable.
6. Performed legal services for client on account \$2,000.
7. Paid monthly expenses: salaries \$500, utilities \$300, and advertising \$100.

### Instructions

- a. Prepare a tabular summary of the transactions.
- b. Prepare the income statement, retained earnings statement, and balance sheet at July 31, 2022, for Legal Services Inc.

### Solution

Trans- action	Assets			=	Liabilities		+	Stockholders' Equity										
	Cash	+	Accounts Receivable	+	Equipment	=	Notes Payable	+	Accounts Payable	+	Common Stock	+	Retained Earnings					
													Rev.	-	Exp.	-	Div.	
(1)	+\$10,000					=					+\$10,000							Issued Stock
(2)	-800					=												Rent Expense
(3)					+\$3,000	=			+\$3,000									
(4)	+1,500					=							+\$1,500					Service Revenue
(5)	+700					=	+\$700											
(6)			+\$2,000			=							+\$2,000					Service Revenue
(7)	-500					=												Sal./Wages Exp.
	-300					=												Utilities Expense
	-100					=												Advertising Expense
	<u>\$10,500</u>	+	<u>\$2,000</u>	+	<u>\$3,000</u>	=	<u>\$700</u>	+	<u>\$3,000</u>	+	<u>\$10,000</u>	+	<u>\$3,500</u>	-	<u>\$1,700</u>			
	\$15,500							\$15,500										

b.

Legal Services Inc. Income Statement For the Month Ended July 31, 2022	
Revenues	
Service revenue	\$3,500
Expenses	
Rent expense	\$800
Salaries and wages expense	500
Utilities expense	300
Advertising expense	100
Total expenses	<u>1,700</u>
Net income	<u>\$1,800</u>

Legal Services Inc. Retained Earnings Statement For the Month Ended July 31, 2022	
Retained earnings, July 1	\$ -0-
Add: Net income	<u>1,800</u>
Retained earnings, July 31	<u>\$1,800</u>

<b>Legal Services Inc.</b>		
<b>Balance Sheet</b>		
<b>July 31, 2022</b>		
<u>Assets</u>		
Cash		\$10,500
Accounts receivable		2,000
Equipment		<u>3,000</u>
Total assets		<u>\$15,500</u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Notes payable	\$ 700	
Accounts payable	<u>3,000</u>	
Total liabilities		\$ 3,700
Stockholders' equity		
Common stock	10,000	
Retained earnings	<u>1,800</u>	<u>11,800</u>
Total liabilities and stockholders' equity		<u>\$15,500</u>

Brief Exercises, DO IT! Exercises, Exercises, Problems, Data Analytics Activities, and many additional resources are available for practice in WileyPLUS.

## Questions

- “Accounting is ingrained in our society and it is vital to our economic system.” Explain why this statement is true or false.
- Identify and describe the activities in the accounting process.
- 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 (a) investors and (b) creditors?
- “Bookkeeping and accounting are the same.” Explain why this statement is true or false.
- Harper Travel Agency purchased land for \$85,000 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 Harper’s balance sheet at December 31, 2022? Explain.
- What is the monetary unit assumption?
- What is the economic entity assumption?
- What are the three basic forms of profit-oriented business organizations?
- Juana Perez is the owner of a successful printing shop. Recently, her business has been increasing, and Juana has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Juana would enjoy if she were to incorporate her business.
- What is the basic accounting equation?
- Define the terms assets, liabilities, and stockholders’ equity.
  - What items affect stockholders’ equity?
- Which of the following items are liabilities of jewelry stores?
  - Cash.
  - Accounts payable.
  - Dividends.
  - Accounts receivable.
  - Supplies.
  - Equipment.
  - Salaries and wages payable.
  - Service revenue.
  - Rent expense.
- Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.
- Are the following events recorded in the accounting records? Explain your answer in each case.
  - The president of the company dies.
  - Supplies are purchased on account.
  - An employee is fired.

16. Indicate how the following business transactions affect the basic accounting equation.
- Paid cash for janitorial services.
  - Purchased equipment for cash.
  - Invested cash in the business for stock.
  - Paid accounts payable in full.
17. Listed below are some items found in the financial statements of Jonas Co. Indicate in which financial statement(s) the following items would appear.
- Service revenue.
  - Equipment.
  - Advertising expense.
  - Accounts receivable.
  - Retained earnings.
  - Salaries and wages payable.
18. In February 2022, Rachel Paige invested an additional \$10,000 in Drumlin Company. Drumlin's accountant, Liz Cooke, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?
19. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's balance sheet." Do you agree? Explain.
20. Monique Enterprises had a stockholders' equity balance of \$158,000 at the beginning of the period. At the end of the accounting period, the stockholders' equity balance was \$198,000.
- Assuming no additional investment or dividends during the period, what is the net income for the period?
  - Assuming an additional investment of \$16,000 but no dividends during the period, what is the net income for the period?
21. Summarized operations for Lakeview Co. for the month of July are as follows.
- Revenues recognized: for cash \$30,000; on account \$70,000.  
Expenses incurred: for cash \$26,000; on account \$38,000.
- Indicate for Lakeview Co. (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.
22. The basic accounting equation is  $\text{Assets} = \text{Liabilities} + \text{Stockholders' equity}$ . Replacing the words in that equation with dollar amounts, what is **Apple's** accounting equation at September 29, 2018?

## Brief Exercises

**BE1.1 (LO 3), AP** The following is the basic accounting equation. Determine the missing amounts.

*Use basic accounting equation.*

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>
a. \$78,000		\$50,000		?
b. ?		\$45,000		\$70,000
c. \$94,000		?		\$60,000

**BE1.2 (LO 3), AP** Given the accounting equation, answer each of the following questions.

*Use basic accounting equation.*

- The liabilities of Holland Company are \$120,000 and its stockholders' equity is \$232,000. What is the amount of Holland Company's total assets?
- The total assets of Holland Company are \$190,000 and its stockholders' equity is \$86,000. What is the amount of its total liabilities?
- The total assets of Holland Company are \$600,000 and its liabilities are equal to one-half of its total assets. What is the amount of Holland Company's stockholders' equity?

**BE1.3 (LO 3), AP** At the beginning of the year, Canon Company had total assets of \$870,000 and total liabilities of \$500,000. Answer the following questions.

*Use basic accounting equation.*

- If total assets increased \$150,000 during the year and total liabilities decreased \$80,000, what is the amount of stockholders' equity at the end of the year?
- During the year, total liabilities increased \$100,000 and stockholders' equity decreased \$66,000. What is the amount of total assets at the end of the year?
- If total assets decreased \$80,000 and stockholders' equity increased \$120,000 during the year, what is the amount of total liabilities at the end of the year?

**BE1.4 (LO 3), AP** Use the accounting equation to answer each of the following questions.

*Solve accounting equation.*

- The liabilities of Olga Company are \$90,000. Common stock account is \$150,000; dividends are \$40,000; revenues, \$450,000; and expenses, \$320,000. What is the amount of Olga Company's total assets?
- The total assets of Lafayette Company are \$57,000. Common stock account is \$23,000; dividends are \$7,000; revenues, \$50,000; and expenses, \$35,000. What is the amount of the company's total liabilities?
- The total assets of Dierdorf Co. are \$600,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Dierdorf Co.'s stockholders' equity?

Identify assets, liabilities, and stockholders' equity.

**BE1.5 (LO 3), C** Indicate whether each of the following items is an asset (A), liability (L), or part of stockholders' equity (SE).

- |                                                        |                                           |
|--------------------------------------------------------|-------------------------------------------|
| <input type="checkbox"/> a. Accounts receivable        | <input type="checkbox"/> d. Supplies      |
| <input type="checkbox"/> b. Salaries and wages payable | <input type="checkbox"/> e. Dividends     |
| <input type="checkbox"/> c. Equipment                  | <input type="checkbox"/> f. Notes payable |

Determine effect of transactions on basic accounting equation.

**BE1.6 (LO 4), C** The following are three business transactions. Create a table with rows (a), (b), and (c), and columns for assets, liabilities, and stockholders' equity. For each column, indicate whether the transactions increased (+), decreased (–), or had no effect (NE) on assets, liabilities, and stockholders' equity.

- Purchased supplies on account.
- Received cash for performing a service.
- Paid expenses in cash.

Determine effect of transactions on accounting equation.

**BE1.7 (LO 4), C** The following are three business transactions. Create a table with rows (a), (b), and (c), and columns for assets, liabilities, and stockholders' equity. For each column, indicate whether the transactions increased (+), decreased (–), or had no effect (NE) on assets, liabilities, and stockholders' equity.

- Stockholders invested cash in the business for common stock.
- Paid a cash dividend.
- Received cash from a customer who had previously been billed for services performed.

Classify items affecting stockholders' equity.

**BE1.8 (LO 4), C** Classify each of the following items as dividends (D), revenue (R), or expense (E).

- |                                                        |                                               |
|--------------------------------------------------------|-----------------------------------------------|
| <input type="checkbox"/> a. Advertising expense        | <input type="checkbox"/> e. Dividends         |
| <input type="checkbox"/> b. Service revenue            | <input type="checkbox"/> f. Rent revenue      |
| <input type="checkbox"/> c. Insurance expense          | <input type="checkbox"/> g. Utilities expense |
| <input type="checkbox"/> d. Salaries and wages expense |                                               |

Determine effect of transactions on stockholders' equity.

**BE1.9 (LO 4), C** The following are three transactions. Mark each transaction as affecting common stock (C), dividends (D), revenue (R), expense (E), or not affecting stockholders' equity (NSE).

- Received cash for services performed
- Paid cash to purchase equipment
- Paid employee salaries

Prepare a balance sheet.

**BE1.10 (LO 5), AP** In alphabetical order below are balance sheet items for Ellerby Company at December 31, 2022. Prepare a balance sheet, following the format of Illustration 1.10.

Accounts payable	\$85,000
Accounts receivable	72,500
Cash	44,000
Common stock	21,500
Retained earnings	10,000

Determine where items appear on financial statements.

**BE1.11 (LO 5), C** Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or retained earnings statement (RE).

- |                                                 |                                             |
|-------------------------------------------------|---------------------------------------------|
| <input type="checkbox"/> a. Notes payable       | <input type="checkbox"/> d. Cash            |
| <input type="checkbox"/> b. Advertising expense | <input type="checkbox"/> e. Service revenue |
| <input type="checkbox"/> c. Common stock        | <input type="checkbox"/> f. Dividends       |

## DO IT! Exercises

Review basic concepts.

**DO IT! 1.1 (LO 1), K** Indicate whether each of the following five 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 resource managers.

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

*Review basic concepts.*

1. Congress passed the Sarbanes-Oxley Act to ensure that investors invest only in companies that will be profitable.
2. 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 money terms.

**DO IT! 1.3 (LO 3), K** Classify the following items as issuance of stock (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases stockholders' equity.

*Evaluate effects of transactions on stockholders' equity.*

1. Dividends.
2. Rent revenue.
3. Advertising expense.
4. Stockholders invest cash in the business.

**DO IT! 1.4 (LO 4), AP** Transactions made by Morlan and Co., a law firm, for the month of March are as follows. Prepare a tabular analysis that shows the effects of these transactions on the accounting equation, similar to that shown in Illustration 1.9.

*Prepare tabular analysis.*

1. The company performed \$23,000 of services for customers, on credit.
2. The company received \$23,000 in cash from customers who had been billed for services (in transaction 1).
3. The company received a bill for \$1,800 of advertising, but will not pay it until a later date.
4. The company paid a dividend of \$5,000 in cash to stockholders.

**DO IT! 1.5 (LO 5), AP** The following is selected information related to Garryowen Company at December 31, 2022. Garryowen reports financial information monthly.

*Determine specific amounts on the financial statements.*

Accounts Payable	\$ 3,000	Salaries and Wages Expense	\$16,500
Cash	9,000	Notes Payable	25,000
Advertising Expense	6,000	Rent Expense	9,800
Service Revenue	54,000	Accounts Receivable	13,500
Equipment	29,000	Dividends	7,500

- a. Determine the total assets of Garryowen Company at December 31, 2022.
- b. Determine the net income that Garryowen Company reported for December 2022.
- c. Determine the stockholders' equity of Garryowen Company at December 31, 2022.

## Exercises

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

*Classify the three activities of accounting.*

- \_\_\_\_\_ Analyzing and interpreting information.
- \_\_\_\_\_ Classifying economic events.
- \_\_\_\_\_ Explaining uses, meaning, and limitations of data.
- \_\_\_\_\_ Keeping a systematic chronological diary of events.
- \_\_\_\_\_ Measuring events in dollars and cents.
- \_\_\_\_\_ Preparing accounting reports.
- \_\_\_\_\_ Reporting information in a standard format.
- \_\_\_\_\_ Selecting economic activities relevant to the company.
- \_\_\_\_\_ Summarizing economic events.

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

Identify users of accounting information.

### Instructions

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

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

- |                                |                                          |
|--------------------------------|------------------------------------------|
| _____ Customers                | _____ Securities and Exchange Commission |
| _____ Internal Revenue Service | _____ Store manager                      |
| _____ Labor unions             | _____ Suppliers                          |
| _____ Marketing manager        | _____ Vice president of finance          |
| _____ Production supervisor    |                                          |

### Instructions

Identify the users as being either **external users (E)** or **internal users (I)**.

**b.** The following questions could be asked by an internal user or an external user.

- \_\_\_\_\_ Can we afford to give our employees a pay raise?
- \_\_\_\_\_ Did the company earn a satisfactory income?
- \_\_\_\_\_ Do we need to borrow in the near future?
- \_\_\_\_\_ How does the company's profitability compare to other companies?
- \_\_\_\_\_ What does it cost us to manufacture each unit produced?
- \_\_\_\_\_ Which product should we emphasize?
- \_\_\_\_\_ 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 (I)** or an **external user (E)**.

Discuss ethics and the historical cost principle.

**E1.3 (LO 2), C** Sam Cresco, president of Cresco Company, has instructed Sharon Gross, the head of the accounting department for Cresco Company, to report the company's land in the company's accounting reports at its fair value of \$170,000 instead of its cost of \$100,000. Cresco says, "Showing the land at \$170,000 will make our company look like a better investment when we try to attract new investors next month."

### Instructions

Explain the ethical situation involved for Sharon Gross, identifying the stakeholders and the alternatives.

Use accounting concepts.

**E1.4 (LO 2), C** The following situations involve accounting principles and assumptions.

- Tina Company owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Tina reports the buildings at fair value in its accounting reports.
- Fayette Company includes in its accounting records only transaction data that can be expressed in terms of money.
- Omar Shariff, president of Omar's Oasis, records his personal living costs as expenses of the Oasis.

### Instructions

For each of the three situations, state 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.

Classify accounts as assets, liabilities, and stockholders' equity.

**E1.5 (LO 3), C** Bailey Cleaners has the following balance sheet items.

Accounts payable	Accounts receivable
Cash	Notes payable
Equipment	Salaries and wages payable
Supplies	Common stock

### Instructions

Classify each item as an asset, liability, or stockholders' equity.

Analyze the effect of transactions.

**E1.6 (LO 4), C** Selected transactions for Verdent Lawn Care Company are as follows.

- Sold common stock for cash to start business.
- Paid monthly rent.
- Purchased equipment on account.



Prepare financial statements.

**E1.9 (LO 5), AP** An analysis of transactions for Foley & Co., a certified public accounting firm, for the month of August is as follows. Assume that August is the company's first month of business.

	Assets				=	Liabilities	+	Stockholders' Equity			
	Cash	Accounts Receivable	Supplies	Equipment				Accounts Payable	+	Common Stock	Retained Earnings
								Rev.	Exp.	Div.	
1.	+\$15,000							+\$15,000			
2.	-2,000			+\$5,000	+\$3,000						
3.	-750		+\$750								
4.	+4,900	+\$4,500						+\$9,400			Service Revenue
5.	-1,500				-1,500						
6.	-2,000									-\$2,000	
7.	-850								-\$ 850		Rent Expense
8.	+450	-450									
9.	-3,900								-3,900		Sal./Wages Expense
10.					+500				-500		Utilities Expense

### Instructions

Prepare an income statement and a retained earnings statement for August and a balance sheet at August 31, 2022.

Determine net income (or loss).

**E1.10 (LO 5), AP** Toth Company had the following assets and liabilities on the dates indicated.

	December 31	Total Assets	Total Liabilities
	2021	\$400,000	\$260,000
	2022	\$480,000	\$300,000
	2023	\$590,000	\$400,000

Toth began business on January 1, 2021, with an investment of \$100,000 from stockholders.

### Instructions

From an analysis of the change in stockholders' equity during the year, compute the net income (or loss) for:

- 2021, assuming Toth paid \$15,000 in dividends for the year.
- 2022, assuming stockholders made an additional investment of \$50,000 and Toth paid no dividends in 2022.
- 2023, assuming stockholders made an additional investment of \$15,000 and Toth paid dividends of \$30,000 in 2023.

Analyze financial statements items.

**E1.11 (LO 5), AN** Two items are omitted from each of the following summaries of balance sheet and income statement data for two corporations for the year 2022, Plunkett Co. and Herring Enterprises.

	Plunkett Co.	Herring Enterprises
Beginning of year:		
Total assets	\$ 97,000	\$122,000
Total liabilities	85,000	(c)
Total stockholders' equity	(a)	75,000
End of year:		
Total assets	160,000	180,000
Total liabilities	120,000	50,000
Total stockholders' equity	40,000	130,000
Changes during year in stockholders' equity:		
Additional investment	(b)	25,000
Dividends	15,000	(d)
Total revenues	215,000	100,000
Total expenses	175,000	55,000

### Instructions

Determine the missing amounts.

**E1.12 (LO 5), AP** The following information relates to La Greca Co. for the year 2022.

Retained earnings, January 1, 2022	\$48,000	Advertising expense	\$ 1,800
Dividends during 2022	5,000	Rent expense	10,400
Service revenue	62,500	Utilities expense	3,100
Salaries and wages expense	28,000		

Prepare income statement and retained earnings statement.

### Instructions

After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2022.

**E1.13 (LO 5), AN** Robyn Howser is the bookkeeper for Madison Company. Robyn has been trying to determine the correct balance sheet for Madison Company, shown as follows.

Correct an incorrectly prepared balance sheet.

Madison Company Balance Sheet December 31, 2022			
Assets		Liabilities	
Cash	\$14,000	Accounts payable	\$15,000
Supplies	3,000	Accounts receivable	(8,500)
Equipment	<u>48,000</u>	Common stock	50,000
Total assets	<u>\$65,000</u>	Retained earnings	<u>8,500</u>
		Total liabilities and stockholders' equity	<u>\$65,000</u>

### Instructions

Prepare a correct balance sheet.

**E1.14 (LO 5), AP** Wyco Park, a public camping ground near the Four Corners National Recreation Area, has compiled the following financial information as of December 31, 2022.

Compute net income and prepare a balance sheet.

Revenues during 2022—camping fees	\$140,000	Notes payable	\$ 60,000
Revenues during 2022—general store	47,000	Expenses during 2022	150,000
Accounts payable	11,000	Supplies on hand	2,500
Cash on hand	20,000	Common stock	20,000
Original cost of equipment	105,500	Retained earnings	?
Fair value of equipment	140,000		

### Instructions

- a. Determine Wyco Park's net income for 2022.
- b. Prepare a balance sheet for Wyco Park as of December 31, 2022.

**E1.15 (LO 5), AP** The following financial information is related to the 2022 operations of Louisa Cruise Company.

Prepare an income statement.

Maintenance and repairs expense	\$ 92,000
Utilities expense	10,000
Salaries and wages expense	142,000
Advertising expense	3,500
Ticket revenue	328,000

### Instructions

Prepare the 2022 income statement for Louisa Cruise Company.

**E1.16 (LO 5), AP** The following information is related to Alexis and Ryans, Attorneys at Law.

Prepare a retained earnings statement.

Retained earnings, January 1, 2022	\$ 23,000
Legal service revenue—2022	340,000
Total expenses—2022	211,000
Assets, January 1, 2022	85,000
Liabilities, January 1, 2022	62,000
Assets, December 31, 2022	168,000
Liabilities, December 31, 2022	80,000
Dividends—2022	64,000

### Instructions

Prepare the 2022 retained earnings statement for Alexis and Ryans, Attorneys at Law.

Prepare a cash flow statement.

**E1.17 (LO 5), AP** This information is for Paulo Company for the year ended December 31, 2022.

Cash received from revenues from customers	\$600,000
Cash received for issuance of common stock	280,000
Cash paid for new equipment	115,000
Cash dividends paid	18,000
Cash paid for expenses	430,000
Cash balance 1/1/22	30,000

### Instructions

Prepare the 2022 statement of cash flows for Paulo Company (see Illustration 1.10).

Identify cash flow activities.

**E1.18 (LO 5), C** The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. Operating activities are the types of activities the company performs to generate profits. Investing activities include the purchase of long-lived assets such as equipment or the purchase of investment securities. Financing activities are borrowing money, issuing shares of stock, and paying dividends.

Presented below are the following transactions.

1. Issued stock for \$20,000 cash.
2. Issued note payable for \$12,000 cash.
3. Purchased office equipment for \$11,000 cash.
4. Received \$15,000 cash for services performed.
5. Paid \$1,000 cash for rent.
6. Paid \$600 cash dividend to stockholders.
7. Paid \$5,700 cash for salaries.

### Instructions

Classify each of these transactions as operating, investing, or financing activities.

## Problems

Analyze transactions and compute net income.



Excel templates for selected exercises and problems provide students a framework for solving in Excel.

**Check figures** provide a key number to let you know you are on the right track.

a. Total assets \$13,560

b. Net income \$4,010

Analyze transactions and prepare income statement, retained earnings statement, and balance sheet.

**P1.1 (LO 4), AP** Fredonia Repair Inc. was started on May 1. A summary of May transactions is presented as follows.

1. Stockholders invested \$10,000 cash in the business in exchange for common stock.
2. Purchased equipment for \$5,000 cash.
3. Paid \$400 cash for May office rent.
4. Paid \$300 cash for supplies.
5. Incurred \$250 of advertising costs in the *Beacon News* on account.
6. Received \$4,700 in cash from customers for repair service.
7. Declared and paid a \$700 cash dividend.
8. Paid part-time employee salaries \$1,000.
9. Paid utility bills \$140.
10. Performed repair services worth \$1,100 on account.
11. Collected cash of \$120 for services billed in transaction (10).

### Instructions

- a. Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Common Stock, and Retained Earnings (with separate columns for Revenues, Expenses, and Dividends). Include margin explanations for any changes in stockholders' equity. Revenue is called Service Revenue.
- b. From an analysis of the Retained Earnings columns, compute the net income or net loss for May.

**P1.2 (LO 4, 5), AP** On August 31, the balance sheet of La Brava Veterinary Clinic showed Cash \$9,000, Accounts Receivable \$1,700, Supplies \$600, Equipment \$6,000, Accounts Payable \$3,600, Common Stock \$13,000, and Retained Earnings \$700. During September, the following transactions occurred.

1. Paid \$2,900 cash for accounts payable due.
2. Collected \$1,300 of accounts receivable.

3. Purchased additional equipment for \$2,100, paying \$800 in cash and the balance on account.
4. Recognized revenue of \$7,300, of which \$2,500 is collected in cash and the balance is due in October.
5. Declared and paid a \$400 cash dividend.
6. Paid salaries \$1,700, rent for September \$900, and advertising expense \$200.
7. Incurred utilities expense for month on account \$170.
8. Received \$10,000 from Capital Bank on a 6-month note payable.

**Instructions**

- a. Prepare a tabular analysis of the September transactions beginning with August 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Common Stock + Retained Earnings + Revenues – Expenses – Dividends.
- b. Prepare an income statement for September, a retained earnings statement for September, and a balance sheet at September 30, 2022.

- a. Ending cash \$15,900
- b. Net income \$4,330  
Total assets \$29,800

**P1.3 (LO 5), AP** On May 1, Nimbus Flying School, a company that provides flying lessons, was started by using common stock in exchange for cash of \$45,000. Following are the assets and liabilities of the company on May 31, 2022, and the revenues and expenses for the month of May.

*Prepare income statement, retained earnings statement, and balance sheet.*

Cash	\$ 4,650		Notes Payable	\$28,000
Accounts Receivable	7,400		Rent Expense	900
Equipment	64,000		Maintenance and	
Service Revenue	6,800		Repairs Expense	350
Advertising Expense	500		Gasoline Expense	2,500
Accounts Payable	1,400		Utilities Expense	400

No additional investments were made in May, but the company paid dividends of \$500 during the month.

**Instructions**

- a. Prepare an income statement and a retained earnings statement for the month of May and a balance sheet at May 31.
- b. Prepare an income statement and a retained earnings statement for May assuming the following data are not included above: (1) \$900 worth of services were performed and billed but not collected at May 31, and (2) \$1,500 of gasoline expense was incurred but not paid.

- a. Net income \$2,150  
Total assets \$76,050
- b. Net income \$1,550

**P1.4 (LO 4, 5), AP** Nancy Tercek started a delivery service, Tercek Deliveries, on June 1, 2022. The following transactions occurred during the month of June.

*Analyze transactions and prepare financial statements.*

- |      |    |                                                                                                                                |
|------|----|--------------------------------------------------------------------------------------------------------------------------------|
| June | 1  | Stockholders invested \$10,000 cash in the business in exchange for common stock.                                              |
|      | 2  | Purchased a used van for deliveries for \$14,000. Nancy paid \$2,000 cash and signed a note payable for the remaining balance. |
|      | 3  | Paid \$500 for office rent for the month.                                                                                      |
|      | 5  | Performed \$4,800 of services on account.                                                                                      |
|      | 9  | Declared and paid \$300 in cash dividends.                                                                                     |
|      | 12 | Purchased supplies for \$150 on account.                                                                                       |
|      | 15 | Received a cash payment of \$1,250 for services performed on June 5.                                                           |
|      | 17 | Purchased gasoline for \$100 on account.                                                                                       |
|      | 20 | Received \$1,500 cash for services performed.                                                                                  |
|      | 23 | Made a cash payment of \$500 on the note payable.                                                                              |
|      | 26 | Paid \$250 for utilities.                                                                                                      |
|      | 29 | Paid for the gasoline purchased on account on June 17.                                                                         |
|      | 30 | Paid \$1,000 for employee salaries.                                                                                            |

**Instructions**

- a. Show the effects of the previous transactions on the accounting equation using the following format.

- a. Total assets \$25,800

		<b>Assets</b>		=	<b>Liabilities</b>		+	<b>Stockholders' Equity</b>			
Date	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Notes Payable	+ Accounts Payable	+ Common Stock	+ Rev.	– Exp.	– Div.

Include margin explanations for any changes in stockholders' equity in your analysis.

- b. Prepare an income statement for the month of June.
- c. Prepare a balance sheet at June 30, 2022.

- b. Net income \$4,450
- c. Cash \$8,100

Determine financial statement amounts and prepare retained earnings statement.

**P1.5 (LO 4, 5), AP Writing** Financial statement information about four different companies is as follows.

	<u>Donatello Company</u>	<u>Leonardo Company</u>	<u>Michelangelo Company</u>	<u>Raphael Company</u>
January 1, 2022				
Assets	\$ 75,000	\$110,000	(g)	\$150,000
Liabilities	48,000	(d)	\$ 75,000	(j)
Stockholders' equity	(a)	60,000	45,000	100,000
December 31, 2022				
Assets	(b)	137,000	200,000	(k)
Liabilities	55,000	75,000	(h)	80,000
Stockholders' equity	40,000	(e)	130,000	140,000
Stockholders' equity changes in year				
Additional investment	(c)	15,000	10,000	15,000
Dividends	6,000	(f)	14,000	10,000
Total revenues	350,000	420,000	(i)	500,000
Total expenses	335,000	382,000	342,000	(l)

### Instructions

- a. Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets – Liabilities = Stockholders' equity = \$27,000.)
- b. Prepare the retained earnings statement for Leonardo Company. Assume beginning retained earnings was \$20,000.
- c. Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the retained earnings statement with the income statement and balance sheet.

b. Retained earnings (ending)  
\$7,000

## Continuing Case



leungchopan/  
Shutterstock.com

The **Cookie Creations** case starts in this chapter and continues through Chapter 13. You also can find this problem in WileyPLUS.

### Cookie Creations

**CC1** Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They passed many happy hours mastering every type of cookie imaginable and later creating new recipes that were both healthy and delicious. Now at the start of her second year in college, Natalie is investigating various possibilities for starting her own business as part of the requirements of the entrepreneurship program in which she is enrolled.

A long-time friend insists that Natalie has to include cookies in her business plan. After a series of brainstorming sessions, Natalie settles on the idea of operating a cookie-making school. She will start on a part-time basis and offer her services in people's homes. Now that she has started thinking about it, the possibilities seem endless. During the fall, she will concentrate on holiday cookies. She will offer individual lessons and group sessions (which will probably be more entertainment than education for the participants). Natalie also decides to include children in her target market.

The first difficult decision is coming up with the perfect name for her business. Natalie settles on "Cookie Creations" and then moves on to more important issues.

### Instructions

- What form of business organization—proprietorship, partnership, or corporation—do you recommend that Natalie use for her business? Discuss the benefits and weaknesses of each form and give the reasons for your choice.
- Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?
- Identify specific asset, liability, and stockholders' equity accounts that Cookie Creations will likely use to record its business transactions.
- Should Natalie open a separate bank account for the business? Why or why not?

## Expand Your Critical Thinking

### Financial Reporting Problem: Apple Inc.

**CT1.1** The financial statements of **Apple Inc.** for 2018 are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

#### Instructions

Refer to Apple's financial statements and answer the following questions.

- What were Apple's total assets at September 29, 2018? At September 30, 2017?
- How much cash (and cash equivalents) did Apple have on September 29, 2018?
- What amount of accounts payable did Apple report on September 29, 2018? On September 30, 2017?
- What were Apple's net sales in 2016? In 2017? In 2018?
- What is the amount of the change in Apple's net income from 2017 to 2018?

### Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

**CT1.2** **PepsiCo's** financial statements are presented in Appendix B. Financial statements of **The Coca-Cola Company** are presented in Appendix C. The complete annual reports of PepsiCo and Coca-Cola, including the notes to the financial statements, are available at each company's respective website.

#### Instructions

- Based on the information contained in these financial statements, determine the following for each company.
  - Total assets at December 29, 2018, for PepsiCo and for Coca-Cola at December 31, 2018.
  - Accounts (notes) receivable, net at December 29, 2018, for PepsiCo and at December 31, 2018, for Coca-Cola.
  - Net revenues for the year ended in 2018.
  - Net income for the year ended in 2018.
- What conclusions concerning the two companies can be drawn from these data?

### Comparative Analysis Problem: Amazon.com, Inc. vs. Walmart Inc.

**CT1.3** **Amazon.com, Inc.'s** financial statements are presented in Appendix D. Financial statements of **Walmart Inc.** are presented in Appendix E. The complete annual reports of Amazon and Walmart, including the notes to the financial statements, are available at each company's respective website.

#### Instructions

- Based on the information contained in these financial statements, determine the following for each company.
  - Total assets at December 31, 2018, for Amazon and for Walmart at January 31, 2019.
  - Receivables (net) at December 31, 2018, for Amazon and for Walmart at January 31, 2019.
  - Net sales (product only) for year ended in 2018 (2019 for Walmart).
  - Net income for the year ended in 2018 (2019 for Walmart).
- What conclusions concerning these two companies can be drawn from these data?

### Decision-Making Across the Organization

**CT1.4** Kathy and James Mohr, local golf stars, opened the Chip-Shot Driving Range Company on March 1, 2022. They invested \$25,000 cash and received common stock in exchange for their investment. A caddy shack was constructed for cash at a cost of \$8,000, and \$800 was spent on golf balls and golf clubs. The Mohrs 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 \$150 was unpaid at March 31, and \$400 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, Kathy and James received a dividend of \$1,000. A \$100 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.

Kathy and James 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 \$2,450.

### Instructions

With the class divided into groups, answer the following.

- How could the Mohrs 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 Mohrs have concluded that the business operated at a net income of \$2,450? (*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

**CT1.5** Ashley Hirano, the bookkeeper for New York Company, has been trying to develop the correct balance sheet for the company. The company's balance sheet is shown as follows.

New York Company Balance Sheet For the Month Ended December 31, 2022			
Assets		Liabilities	
Equipment	\$25,500	Common stock	\$22,000
Cash	9,000	Accounts receivable	(6,000)
Supplies	2,000	Retained earnings	2,000
Accounts payable	(8,000)	Notes payable	10,500
	\$28,500		\$28,500

### Instructions

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

### Ethics Case

**CT1.6** After numerous campus interviews, Greg Thorpe, 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, Greg received two checks in the mail, each in the amount of \$296.

### Instructions

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

### All About You

**CT1.7** Some people are tempted to make their finances look worse to get college 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, taken 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?

**CT1.8** When companies need money, they go to investors or creditors. Before investors or creditors will give a company cash, they want to know the company's financial position and performance. They want to see the company's financial statements—the balance sheet and the income statement. When students need money for school, they often apply for financial aid. When you apply for financial aid, you must submit your own version of a financial statement—the Free Application for Federal Student Aid (FAFSA) form.

Suppose you have \$4,000 in cash and \$4,000 in credit card bills. The more cash and other assets that you have, the less likely you are to get financial aid. Also, if you have a lot of consumer debt (credit card bills), schools are less likely to loan you money. To increase your chances of receiving aid, should you use the cash to pay off your credit card bills and therefore make yourself look "worse off" to the financial aid decision-makers?

**YES:** You are playing within the rules. You are not hiding assets. You are simply restructuring your assets and liabilities to best conform with the preferences that are built into the federal aid formulas.

**NO:** You are engaging in a transaction solely to take advantage of a loophole in the federal aid rules. In doing so, you are potentially depriving someone who is actually worse off than you from receiving aid.

### Instructions

Write a response indicating your position regarding this situation. Provide support for your view.

### FASB Codification Activity

**CT1.9** The FASB has developed the Financial Accounting Standards Board Accounting Standards Codification (or more simply "the Codification"). The FASB's primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic. To provide easy access to the Codification, the FASB also developed the Financial Accounting Standards Board Codification Research System (CRS). CRS is an online, real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system.

You may find this system useful in your present and future studies, and so we have provided an opportunity to use this online system as part of the *Expand Your Critical Thinking* section.

### Instructions

Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should log in and familiarize yourself with the resources that are accessible at the FASB Codification site.

### Considering People, Planet, and Profit

**CT1.10** Although **Clif Bar & Company** is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts.

### Instructions

Go to the Who We Are page of the Clif Bar website and identify the five aspirations.

## Answers to Insight and Accounting Across the Organization Questions

**Owning a Piece of the Bar** **Q:** What are the benefits to the company and to the employees of making the financial statements available to all employees? **A:** If employees can read and use financial reports, a company will benefit in the following ways. The **marketing department** will make better decisions about products to offer and prices to charge. The **finance department** will make better decisions about debt and equity financing and how much to distribute in dividends. The **production department** will make better decisions about when to buy new equipment and how much inventory to produce. The **human resources department** will be better able to determine whether employees can be given raises. Finally, **all employees** will be better informed about the basis on which they are evaluated, which will increase employee morale.

**I Felt the Pressure—Would You?** **Q:** Why did these employees lie, and what do you believe should be their penalty for these lies? **A:** They felt pressured by their supervisors to make the company's financial statements look better than warranted. They should be prosecuted for fraudulent activities under the Sarbanes-Oxley Act, as they knowingly misstated financial statement data.

**The Korean Discount** **Q:** What is meant by the phrase “make the country's business more transparent”? Why would increasing transparency spur economic growth? **A:** Transparency refers to the extent to which outsiders have knowledge regarding a company's financial performance and financial position. If a company lacks transparency, its financial reports do not adequately inform investors of critical information that is needed to make investment decisions. If corporate transparency is increased, investors would be more willing to supply the financial capital that businesses need in order to grow, which would spur the country's economic growth.

**Spinning the Career Wheel** **Q:** How might accounting help you? **A:** You will need to understand financial reports in any enterprise with which you are associated. Whether you become a manager, a doctor, a lawyer, a social worker, a teacher, an engineer, an architect, or an entrepreneur, a working knowledge of accounting is relevant.

**Beyond Financial Statements** **Q:** Why might a company's stockholders be interested in its environmental and social performance? **A:** Many companies now recognize that being a socially responsible organization is not only the right thing to do, but it also is good for business. Many investment professionals understand, for example, that environmental, social, and proper corporate governance of companies affects the performance of their investment portfolios. For example, **British Petroleum's** oil spill disaster is a classic example of the problems that can occur for a company and its stockholders. BP's stock price was slashed, its dividend reduced, its executives replaced, and its reputation badly damaged. It is interesting that socially responsible investment funds are now gaining momentum in the marketplace such that companies now recognize this segment as an important investment group.

## A Look at IFRS

### LEARNING OBJECTIVE 7

Describe the impact of international accounting standards on U.S. financial reporting.

Most agree that there is a need for one set of international accounting standards. Here is why:

**Multinational corporations.** Today's companies view the entire world as their market. For example, **Coca-Cola**, **Intel**, and **McDonald's** generate more than 50% of their sales outside the United States. Many foreign companies, such as **Toyota**, **Nestlé**, and **Sony**, find their largest market to be the United States.

**Mergers and acquisitions.** The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations of companies from different countries in the future.

**Information technology.** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.

**Financial markets.** Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

## Key Points

Following are the key similarities and differences between GAAP and IFRS as related to accounting fundamentals.

### Similarities

- The basic techniques for recording business transactions are the same for U.S. and international companies.
- Both international and U.S. accounting standards emphasize transparency in financial reporting. Both sets of standards are primarily driven by meeting the needs of investors and creditors.
- The three most common forms of business organizations, proprietorships, partnerships, and corporations, are also found in countries that use international accounting standards.

### Differences

- International standards are referred to as International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board. Accounting standards in the United States are referred to as generally accepted accounting principles (GAAP) and are developed by the Financial Accounting Standards Board.
- IFRS tends to be simpler in its accounting and disclosure requirements; some people say it is more “principles-based.” GAAP is more detailed; some people say it is more “rules-based.”
- The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation.

## IFRS Practice

### IFRS Self-Test Questions

1. Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?
  - a. Mergers and acquisition activity.
  - b. Financial markets.
  - c. Multinational corporations.
  - d. GAAP is widely considered to be a superior reporting system.
2. The Sarbanes-Oxley Act determines:
  - a. international tax regulations.
  - b. internal control standards as enforced by the IASB.
  - c. internal control standards of U.S. publicly traded companies.
  - d. U.S. tax regulations.
3. IFRS is considered to be more:
  - a. principles-based and less rules-based than GAAP.
  - b. rules-based and less principles-based than GAAP.
  - c. detailed than GAAP.
  - d. None of the answer choices is correct.

### IFRS Exercises

**IFRS1.1** Who are the two key international players in the development of international accounting standards? Explain their role.

**IFRS1.2** What is the benefit of a single set of high-quality accounting standards?

### International Financial Reporting Problem: Louis Vuitton

**IFRS1.3** The financial statements of **Louis Vuitton** are presented in Appendix F. The complete consolidated financial statements, including the notes to its financial statements, are available at the company's website.

#### Instructions

Visit Louis Vuitton's corporate website and answer the following questions from the company's 2018 consolidated financial statements.

- a. What accounting firm performed the audit of Louis Vuitton's financial statements?
- b. What is the address of the company's corporate headquarters?
- c. What is the company's reporting currency?

#### Answers to IFRS Self-Test Questions

1. d 2. c 3. a

