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- » Examining the three primary business financial statements
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Chapter 1

Business Accounting Fundamentals

The purpose of Chapter 1 is relatively simple as the goal is to provide an introduction to the fundamentals of accounting and its importance to businesses. In this chapter, I cover some extremely basic accounting concepts, ideas, and theories that rain or shine, in good times or bad, act as the bedrock of business accounting. Or looking at accounting from a different perspective, I'm drawn to a question my nephew posed to me that caught me somewhat off guard. Simply put, he asked "What is the purpose of accounting?" To this, I responded with two thoughts:

- » First, accounting represents the foundation of fairly reporting the financial performance of a business over a period of time (for example, the income statement and statement of cash flows) or a business's financial strength at a point in time (as in the balance sheet). Accounting, when properly functioning, should clearly and fairly measure the economic performance of a legal entity.
- » Second, accounting takes on the added responsibility of safeguarding a legal entity's assets and protecting the economic value of a business.

But, before the accounting process can even begin, a starting point must be established, which is identifying the entity being accounted for. A business entity can be legally organized as

a partnership, corporation, limited liability company, or other structure permitted by law. Alternatively, a business entity simply may consist of the business activities of an individual, in which case it's called a sole proprietorship. Regardless of how the business entity is legally established, it's treated as a separate entity or distinct person for accounting purposes. And once a legal entity is established, the accounting process can proceed.

Keeping the Accounting Equation in Balance

If you've ever studied accounting, you probably recall the most fundamental accounting equation there is:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Owners' Equity}$$

The accounting equation says a lot in very few words. It's like the visible part of an iceberg — a lot of important points are hidden under the water. Notice the two sides to the equation: assets on one side and the claims against the assets on the other side. These claims arise from credit extended to the business (liabilities) and capital invested or retained by owners in the business (owners' equity). (The claims of liabilities are significantly different than the claims of owners; liabilities have seniority and priority for payment over the claims of owners.)

Capital invested means actual investments made in the company by the owners. *Retained by owners* refers to net profits earned by the company that are retained internally, less any distributions or dividends paid to the owners and less any net losses the company may have incurred over the year. In the next paragraph, a total of \$6 million of owners' equity is referenced, which could come from \$6 million of cash being invested in the company by the owners or it could be the result of \$4 million of invested cash, plus \$3 million of retained net profits, less \$1 million of previous owner dividends. Under either scenario, total owners' equity amounts to \$6 million; it just so happens that it comes from different sources.

Suppose a business has \$10 million total assets. These assets didn't fall down like manna from heaven (as our old accounting professors were fond of saying). The money for the assets came from somewhere. The business's creditors (to whom it owes its liabilities) may have supplied, say, \$4 million of its total assets. Therefore, the owners' equity sources provided the other \$6 million.



REMEMBER

Business accounting is based on the two-sided nature of the accounting equation. Both assets and sources of assets are accounted for, which leads, quite naturally, to double-entry accounting. Double entry, in essence, means two-sided. It's based on the general economic exchange model. In economic transactions, something is given, and something is received in exchange. For example, I recently bought an iPod from Apple Computer. Apple gave me the iPod and received my money. Another example involves a business that borrows money from its bank. The business gives the bank a legal instrument called a note promising to return the money at a future date and to pay interest over the time the money is borrowed. In exchange for the note, the business receives the money. (Chapter 3 explains how to implement double-entry accounting.)

- Q.** Is each of the following equations correct? What key point does each equation raise?
- a. $\$250,000 \text{ Assets} = \$100,000 \text{ Liabilities} + \$100,000 \text{ Owners' Equity}$
 - b. $\$2,345,000 \text{ Assets} = \$46,900 \text{ Liabilities} + \$2,298,100 \text{ Owners' Equity}$
 - c. $\$26,450 \text{ Assets} = \$675,000 \text{ Liabilities} - \$648,550 \text{ Owners' Equity}$
 - d. $\$4,650,000 \text{ Assets} = \$4,250,000 \text{ Liabilities} + \$400,000 \text{ Owners' Equity}$

- A.** Each accounting equation offers an important lesson.
- a. Whoops! This accounting equation doesn't balance, so clearly something's wrong. Either liabilities, owner's equity, or some combination of both is \$50,000 too low, or the two items on the right-hand side could be correct, in which case total assets are overstated \$50,000. With an unbalanced equation such as this, the accountant definitely should find the error or errors and make appropriate correcting entries.
 - b. This accounting equation balances, but, wow! Look at the very small size of liabilities relative to assets. This kind of contrast isn't typical. The liabilities of a typical business usually account for a much larger percentage of its total assets.
 - c. This accounting equation balances, but the business has a large negative owners' equity. Such a large negative amount of owners' equity means the business has suffered major losses that have wiped out almost all its assets. You wouldn't want to be one of this business's creditors (or one of its owners either).
 - d. This accounting equation balances and is correct, but you should notice that the business is highly leveraged, which means the ratio of debt to equity (liabilities divided by owners' equity) is very high, more than 10 to 1. This ratio is quite unusual.

1 Which of the following is the normal way to present the accounting equation?

- a. $\text{Liabilities} = \text{Assets} - \text{Owners' Equity}$
- b. $\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$
- c. $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$
- d. $\text{Assets} - \text{Liabilities} - \text{Owners' Equity} = 0$

2 A business has \$485,000 total liabilities and \$1,200,000 total owners' equity. What is the amount of its total assets?

3 A business has \$250,000 total liabilities. At start-up, the owners invested \$500,000 in the business. Unfortunately, the business has suffered a cumulative loss of \$200,000 up to the present time. What is the amount of its total assets at the present time?

4 A business has \$175,000 total liabilities. At start-up, the owners invested \$250,000 capital. The business has earned \$190,000 cumulative profit since its creation, all of which has been retained in the business. What is the total amount of its assets?

Distinguishing Between Cash- and Accrual-Basis Accounting

Cash-basis accounting refers to keeping a record of cash inflows and cash outflows. An individual uses cash-basis accounting in keeping his checkbook because he needs to know his day-to-day cash balance and he needs a journal of his cash receipts and cash expenditures during the year for filing his annual income tax return. Individuals have assets other than cash (such as cars, computers, and homes), and they have liabilities (such as credit card balances and home mortgages). Hardly anyone I know keeps accounting records of their personal noncash assets and their liabilities (aside from putting bills to pay and receipts for major purchases in folders). Most people either maintain a checkbook (for all the old-timers out there) or in today's digital world, manage their banking online and maintain a virtual, real-time summary of inflows and outflows to their bank account. That's about it when it comes to their personal accounting.

Although it's perfect for individuals, cash-basis accounting just doesn't cut it for the large majority of businesses. Cash-basis accounting doesn't provide the information that managers need to run a business, or the information needed to prepare company tax returns and financial reports. Some small personal service businesses (such as barber shops, lawyers, and real estate brokers) can get by using cash-basis accounting because they have virtually no assets other than cash, and they pay their bills right away.

The large majority of businesses use accrual-basis accounting. They keep track of their cash inflows and outflows, of course, but accrual-basis accounting allows them to record all the assets and liabilities of the business. Also, accrual-basis accounting keeps track of the money invested in the business by its owners and the accumulated profit retained in the business. In short, accrual-basis accounting has a much broader scope than cash-basis accounting.

A big difference between cash- and accrual-basis accounting concerns how they measure annual profit of a business. With cash-basis accounting, profit simply equals the total of cash inflows from sales minus the total of cash outflows for expenses of making sales and running the business, or, in other words, the net increase in cash from sales and expenses. With the

accrual-basis accounting method, profit is measured differently because the two components of profit — sales revenue and expenses — are recorded differently.



REMEMBER

When using accrual-basis accounting, a business records sales revenue when a sale is made and the products and/or services are delivered to the customer, whether the customer pays cash on the spot or receives credit and doesn't pay the business until sometime later. Sales revenue is recorded before cash is actually received. The business doesn't record the cost of the products sold as an expense until sales revenue is recorded, even though the business paid out cash for the products weeks or months earlier. Furthermore, with accrual-basis accounting, a business records operating expenses as soon as they're incurred (as soon as the business has a liability for the expense), even though the expenses aren't paid until sometime later.

Cash-basis accounting doesn't reflect economic reality for businesses that sell and buy on credit (which is how the vast majority of companies operate in today's economy), carry inventories of products for sale, invest in long-lived operating assets, and make long-term commitments for such things as employee pensions and retirement benefits. When you look beyond small cash-based business, you quickly realize that businesses need the comprehensive recordkeeping system called accrual-basis accounting. I like to call it "economic reality accounting."

The following example question focuses on certain fundamental differences between cash-basis and accrual-basis accounting regarding the recording of sales revenue and expenses for the purpose of measuring profit.

- Q.** You started a new business one year ago. You've been very busy dealing with so many problems that you haven't had time to sit down and look at whether you made a profit or not. You haven't run out of cash (which for a start-up venture is quite an accomplishment), but you understand that the sustainability of the business depends on making a profit. The following two summaries present cash-flow information for the year and information about two assets and a liability at year-end:

Revenue and Expense Cash Flows for First Year

\$558,000 cash receipts from sales

\$375,000 cash payments for purchases of products

\$340,000 cash payments for other expenses

Two Assets and a Liability at Year-End

\$52,000 receivables from customers for sales made to them during the year

\$85,000 cost of products in ending inventory that haven't yet been sold

\$25,000 liability for unpaid expenses

Compare the profit or loss of your business for its first year according to the cash- and accrual-basis accounting methods.

- A.** Profit according to cash-basis accounting equals the cash inflow from sales minus the total of cash outflows for expenses (and the total of cash outflows for expenses equals the purchases of products plus other expenses). Thus, under cash-basis accounting, your business has a \$157,000 loss for the year (\$558,000 sales revenue – \$715,000 expenses = \$157,000 loss).

Under accrual-basis accounting, you record different amounts for sales revenue and the two expenses, which are calculated as follows:

$\$558,000$ cash receipts from sales + $\$52,000$ year-end receivables from customers = $\$610,000$ sales revenue

$\$375,000$ cash payments for purchases of products – $\$85,000$ year-end inventory of unsold products = $\$290,000$ cost of products sold expense

$\$340,000$ cash payments for other expenses + $\$25,000$ year-end liability for unpaid expenses = $\$365,000$ other expenses

Deducting cost of products sold and other expenses from sales revenue gives a net loss of $\$45,000$ ($\$610,000$ sales revenue – $\$290,000$ cost of products sold – $\$365,000$ other expenses = $\$45,000$ net loss for year).

To answer Questions 5 through 8, please refer to the summary of revenue and expense cash flows and the summary of two assets and a liability at year-end presented in the preceding example question.

5 What would be the amount of accrual-basis sales revenue for the year if the business's year-end receivables had been $\$92,000$?

6 What would be the amount of accrual-basis cost of products sold expense for the year if the business's cost of products held in inventory at year-end had been $\$95,000$?

7 What would be the amount of accrual-basis other expenses for the year if the business's liability for unpaid expenses at year-end had been $\$30,000$?

8 Based on the changes for the example given in Questions 5, 6, and 7, determine the profit or loss of the business for its first year.

Summarizing Profit Activities in the Income (Profit & Loss) Statement

As crass as it sounds, business managers get paid to make profit happen. Management literature usually stresses the visionary, leadership, and innovative characteristics of business managers, but these traits aren't worth much if the business suffers losses year after year or fails to establish sustainable profit performance. After all, businesses are profit-motivated, aren't they?

It's not surprising that the income statement takes center stage in business financial reports. The income statement summarizes a company's revenue and other income, expenses, losses, and bottom-line profit or loss for a period of time. It is important to indicate with the income statement what period of time it covers. To say a business generated net income of \$10,000 is meaningless if the period for which this profit was generated is not also presented.

The income statement tends to get top billing over the other two primary financial statements (the balance sheet and the statement of cash flows), which I discuss later in this chapter. The income statement is referred to informally as the Profit & Loss or P&L statement, although these titles are seldom used in external financial reports. (Alternatively, it may be titled Earnings Statement or Statement of Operations.)

Financial reporting standards demand that an income statement be presented in quarterly and annual financial reports to owners. But financial reporting rules are fairly permissive regarding exactly what information should be reported and how it's presented (see Chapter 7 for the full scoop on income statement disclosure).

- Q.** Take a look at this extremely abbreviated and condensed income statement for a business's most recent year. (*Note:* A formal income statement in a financial report must disclose more information than this.)

Income Statement for Year

Sales revenue	\$26,000,000
Expenses	<u>24,310,000</u>
Net income	\$1,690,000

This business sells products, which are also called goods or merchandise. The cost of products sold to customers during the year was \$14,300,000. Expand the condensed income statement to reflect this additional information.

- A.** Income statement reporting requires a company to show the cost of goods (products) sold as a separate expense and deduct it immediately below sales revenue. The difference must be reported as gross profit (or gross margin). Therefore, the condensed income statement should be expanded as follows:

Income Statement for Year

Sales revenue	\$26,000,000
Cost of goods sold	<u>14,300,000</u>
Gross profit	\$11,700,000
Other expenses	<u>10,010,000</u>
Net income	\$1,690,000

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- 9 One rule of income statement reporting is that interest expense and income tax expense be reported separately. The \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$350,000 interest expense and \$910,000 income tax. Rebuild the income statement given the information for these additional two expenses. Hint: Profit before interest expense is usually labeled “operating earnings,” and profit after interest and before income tax expense is usually labeled “earnings before income tax.”
- 10 No specific rule governs income statement disclosure of advertising expense. Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$5,000,000 of advertising expense. Would you favor reporting this as a separate expense in the income statement? Hint: This question calls for your opinion only.
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- 11 No specific rule governs income statement disclosure of executive-level compensation. Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$3,000,000 of executive-level compensation that includes both base salaries and generous bonuses. Would you favor reporting this as a separate expense in the income statement? Hint: This question calls for your opinion only.
- 12 Suppose the business distributed \$650,000 cash to its shareowners from its profit (net income) for the year in the form of a dividend. Is this cash disbursement treated as an expense?
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Assembling a Balance Sheet

The balance sheet is one of the three primary financial statements that businesses report (the other two being the income statement and the cash flow statement or statement of cash flows). The balance sheet summarizes the assets, liabilities, and owners' equity accounts of a business at an instant in time. Prepared at the close of business on the last day of the profit period, the balance sheet presents a “freeze frame” look at the business's financial condition.



REMEMBER

Preparing and reporting a balance sheet takes time, so by the time you read a balance sheet, it's already out-of-date. The business's stream of activities and operations doesn't stop, which means that from the date at which the balance sheet was prepared to when you read it, the business will have engaged in many transactions. These subsequent transactions may have significantly changed its financial condition. For more on the balance sheet, turn to Chapter 8.



TIP

In accounting, the term *balance* refers to the dollar amount of an account, after recording all increases and decreases in the account caused by business activities over a defined period of time. The balance sheet reports the balances of asset, liability, and owners' equity accounts, but it also refers to the equality, or balance, of the accounting equation (see the section “Keeping the Accounting Equation in Balance” earlier in this chapter).

Balance sheets normally list assets and liabilities in order of liquidity. Liquidity means how easy it is to change an asset or a liability into cash. For example: Cash is first in the list of assets, followed by accounts receivable, which are usually turned into cash in 30 days or less. Inventory is next because it usually will be sold and turned into cash within the next 90 days. And equipment, land, and buildings come last because they usually will be held for many years.

On the liability side of the balance sheet, accounts payable, accrued liabilities, and other current liabilities (such as sales tax payable) come first because they are usually paid within 30 to 90 days. Notes payable and payments on long-term loans come next; they're usually paid within a year. And long-term loans that will not be paid within the next year come last. Liabilities come before owners' equity, both due to timing and to agreeing with the order in the accounting equation.



EXAMPLE

Q. The following list summarizes the assets and liabilities of a business at the close of business on the last day of its most recent profit period:

Amounts owed by customers to the business (such as trade accounts receivable):
\$485,000

Cost of unsold products that will be sold in future periods (such as inventory):
\$678,000

Cash balance on deposit in checking account with bank: \$396,000

Amounts owed by business for unpaid purchases and expenses (such as trade accounts payable): \$438,000

Notes payable to bank (on which interest is paid): \$500,000

Original cost of long-term operating assets (such as machinery and equipment) that are being depreciated over their useful lives to the business: \$950,000

Accumulated depreciation of long-term operating assets: \$305,000

Using this information, prepare the business's balance sheet.

A.	Cash	\$396,000	Accounts Payable	\$438,000
	Accounts Receivable	\$485,000	Notes Payable	\$500,000
	Inventory	\$678,000	Owners' Equity*	<u>\$1,266,000</u>
	Fixed Assets (Net of Accumulated Depreciation)	<u>\$645,000</u>		
	Total Assets	\$2,204,000	Total Liabilities and Owners' Equity	\$2,204,000

*Owners' equity is determined by deducting the sum of liabilities from total assets.

Note: This balance sheet isn't classified into current assets and current liabilities. Also, owners' equity isn't classified. (Chapter 8 explains the balance sheet in greater detail.)

Use the balance sheet shown in the preceding example to answer Questions 13 through 16.

13 Suppose \$950,000 of owners' equity consists of profit earned and not distributed by the business. What is this amount usually called in the balance sheet? And, what is the other amount of owners' equity called in the balance sheet?

14 It appears that the business can't pay its liabilities. The two liabilities total \$938,000, but the business has a cash balance of only \$396,000. Do you agree?

15 Can you tell the amount of profit the business earned in the period just ended?

16 In a balance sheet, assets usually are listed in the order of their "nearness" to cash. Cash is listed first, followed by the asset closest to being converted into cash, and so on. Is the sequence of assets according to normal rules for presenting assets in balance sheets?

Partitioning the Statement of Cash Flows

You could argue that the statement of cash flows is the most important of the three primary financial statements. Why? Because in the long run everything comes down to cash flows. Profit recorded on the accrual basis of accounting has to be turned into cash — and the sooner the better. Otherwise, profit doesn't provide money for growing the business and paying distributions to owners. I have never known a business to fail and go bankrupt because it ran out of assets. Businesses fail because they run out of cash; either from operations not generating cash, lenders unwilling to loan the business cash, or investors not willing to invest more cash. These three elements are disclosed in the statement of cash flows.

By themselves, the income statement and balance sheet don't provide information about the cash flow generated by the business's profit-making, or operating, activities. But people who use financial reports (business managers, lenders, and investors) want to see cash flow information. In short, financial reporting standards require a statement of cash flows. The statement of cash flows begins where the income statement finished off, by presenting the net income or loss for the like reporting period. After this, the statement of cash flows reports cash increases and decreases in three main buckets or groups of information as follows:

- » **Operating activities:** This section of the statement of cash flows starts with the net profit or loss generated by the company over the period and then captures changes in cash occurring from normal operating activity such as increases or decreases in trade accounts receivable, inventory, trade accounts payable, accrued liabilities, and other current assets and liabilities. In addition, you will also note that operating activities include adding back the amount recorded for depreciation and amortization expense. The reason for this is that these expenses represent "non cash" charges to the income statement to account for the periodic estimated use of assets over a period of time. I discuss depreciation and amortization expense in more detail in Chapter 6.
- » **Investing activities:** Include the purchase and construction of long-term operating assets such as land, buildings, equipment, machinery, vehicles, and tools. If a business realizes cash from the disposal of such assets, the proceeds are included in this category of cash flows.
- » **Financing activities:** Include borrowing money from debt sources and paying loans at maturity as well as raising capital from shareowners and returning capital to them. Cash distributions from profit are included in this category of cash flows.



EXAMPLE

- Q.** The statement of cash flows for a business's most recent year is presented as follows. Based on the information provided, is it possible to determine the amount of cash flow from operating activities?

Cash flow from operating activities:		?????
Cash flow from investing activities:		
Capital expenditures	(\$2,345,000)	
Proceeds from disposal of real estate	<u>\$225,000</u>	(\$2,120,000)
Cash flow from financing activities:		
Increase in debt	\$1,625,000	
Issue of capital stock shares	\$550,000	
Cash dividends to shareholders	<u>(\$400,000)</u>	<u>\$1,775,000</u>
Net cash increase during year		\$355,000

- A.** You can determine the amount of cash flow from operating activities by the following calculations:

\$2,120,000 net cash needed for capital expenditures + \$355,000 cash balance increase = \$2,475,000 total cash needed

\$2,475,000 total cash needed – \$1,775,000 net cash provided from financing activities = \$700,000 cash flow from operating activities

Cash flow from operating activities is explained in more detail in Chapter 8.

You can condense a statement of cash flows, such as the one for the example, into its four basic components as follows (negative numbers appear in parentheses):

Cash flow from operating activities	\$700,000
Cash flow from investing activities	(\$2,120,000)
Cash flow from financing activities	\$1,775,000
Net increase in cash during the year	\$355,000



TIP

If you know three of the four components in a condensed statement of cash flows, you can determine the fourth factor. Suppose you know the increase or decrease in cash during the year (which is easy enough to determine by comparing the ending cash balance with the beginning cash balance). And suppose you can quickly determine the cash flow from investing activities and the cash flow from financing activities (because there aren't many transactions of these two types during the year). Knowing these three factors, you can quickly determine the cash flow from operating activities. The remainder of the increase or decrease in cash during the year is attributable to operating activities.

Questions 17 through 20 give you three of the four components in a condensed statement of cash flows and ask you to solve for the unknown factor.

17 Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	\$450,000
Cash flow from investing activities	(\$725,000)
Cash flow from financing activities	<u>\$50,000</u>
Net increase (decrease) in cash during the year	????

Determine the increase or decrease in cash during the year.

18 Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	\$2,680,000
Cash flow from investing activities	????
Cash flow from financing activities	<u>\$1,250,000</u>
Net increase (decrease) in cash during the year	\$400,000

Determine cash flow from investing activities for the year.

19 Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	\$650,000
Cash flow from investing activities	(\$925,000)
Cash flow from financing activities	????
Net increase (decrease) in cash during the year	(\$65,000)

Determine cash flow from financing activities for the year.

20 Three of the four components of cash flow for the year of a business are as follows:

Cash flow from operating activities	????
Cash flow from investing activities	(\$480,000)
Cash flow from financing activities	<u>(\$150,000)</u>
Net increase (decrease) in cash during the year	\$150,000

Determine cash flow from operating activities for the year.

Tracing How Dishonest Accounting Distorts Financial Statements

It goes without saying that a business should keep its accounting system as honest as the day is long. In preparing its financial statements, a business should be forthright and not misleading. As the late sportscaster Howard Cosell would say, “Tell it like it is.” I regret to inform you that some businesses might “tweak” their financial results, others may have errors present in their financial statements, and in a few cases, outright misrepresent their accounting and financial reporting. So, what’s the difference?

First, many businesses perform a light amount of cosmetic surgery (also known as tweaking) on their accounting records, touching up their financial condition and profit performance to achieve a specific objective. This practice is popularly called “massaging the numbers” or “financial statement dressing.” Professional investors (as in mutual fund managers) and lenders (as in banks) know that a certain amount of accounting manipulation goes on by many businesses, and as a practical matter not much can be done about it (so it is generally tolerated to a large extent).

Second, companies that have relatively poor accounting systems, inexperienced staff, limited financial management infrastructure, and/or that lack proper policies, procedures, and internal controls, may in fact present financial statements that contain errors. It is important to note that presenting financial statements with an error (which may not even be known to the management team) does not mean that the company is intentionally undertaking fraudulent activity. Rather, when errors are present, it’s usually due to a lack of accounting knowledge. I’m not attempting to defend companies that have accounting errors present, but there is a significant difference in the intent of management in financial information that has been reported with an error (unintentional) versus a direct misrepresentation (an intentional effort to mislead), which is often referred to as an accounting “irregularity.”



WARNING

Third, some businesses (but thankfully a small minority) resort to outright accounting fraud to put a better sheen on profit performance and conceal financial problems. Accounting fraud is popularly called “cooking the books.” On one end, think of massaging the numbers as fibbing or putting a spin on the truth and on the other end, accounting fraud as out-and-out lying with the intent to deceive and mislead. Over the past 20 years, legislation has been enacted to help combat accounting fraud, especially after the Enron debacle and bankruptcy in 2001 (the largest at its time). Although progress has been made, accounting fraud still occurs as evidenced by the Wirecard fraud, which reached its peak in 2020. It seems no matter how hard the authorities try, a small number of criminals continue to front run legislation, controls, and regulations to commit accounting fraud. Accounting fraud is illegal, and perpetrators are subject to prosecution under criminal law. Plus, victims can sue the persons responsible for the fraud.



EXAMPLE

Q. Suppose a business has engaged in some accounting fraud to boost its profit for the year just ended. Assume that the business didn't commit any accounting fraud before this year (which may not be true, of course). As the result of fraudulent entries in its accounts, the \$2,340,000 bottom-line profit reported in its income statement was overstated by \$385,000. How does this dishonest accounting distort the business's balance sheet?

A. Owners' equity is overstated by \$385,000 because profit increases owners' equity. And the overstatement of profit may have involved the overstatement of assets, the understatement of liabilities, or a combination of both. To correct this error, owners' equity should be decreased \$385,000. As well, assets should be decreased \$385,000, or liabilities should be increased \$385,000 (or some combination of both).

21 Suppose a business commits accounting fraud by deliberately not writing down its inventory of \$268,000, which is the cost of certain products that it can no longer sell and will be thrown in the junk heap. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects? (Use the answer template provided.)

Cash		Accounts Payable	
Accounts Receivable		Notes Payable	
Inventory		Owners' Equity	
Fixed Assets (Net of Accumulated Depreciation)	_____		_____
Total Assets		Total Liabilities and Owners' Equity	

22 Suppose a business commits accounting fraud by deliberately not recording \$465,000 liabilities for unpaid expenses at the end of the year. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects? (Use the answer template provided.)

Cash		Accounts Payable	
Accounts Receivable		Notes Payable	
Inventory		Owners' Equity	
Fixed Assets (Net of Accumulated Depreciation)	_____		_____
Total Assets		Total Liabilities and Owners' Equity	

Answers to Problems on Elements of Business Accounting

The following are the answers to the practice questions presented earlier in this chapter.

- 1 Which of the following is the normal way to present the accounting equation?
c. Assets = Liabilities + Owners' Equity

The other three accounting equations are correct from the algebraic equation point of view. However, the accounting equation is usually shown with assets on one side and the two broad classes of claims against the assets on the other side. *Note:* You see answer (b) (Assets – Liabilities = Owners' equity) when the purpose is to emphasize the net worth of a business, or its assets less its liabilities.
- 2 A business has \$485,000 total liabilities and \$1,200,000 total owners' equity. What is the amount of its total assets?

Total assets = \$1,685,000, which is the total of \$485,000 liabilities plus \$1,200,000 owners' equity.
- 3 A business has \$250,000 total liabilities. When it was started the owners invested \$500,000 in the business. Unfortunately, the business has suffered a cumulative loss of \$200,000 up to the present time. What is the amount of its total assets at the present time?

Total assets = \$550,000, which is the total of \$250,000 liabilities plus \$300,000 owners' equity.

Notice that the original \$500,000 that the owners invested in the business is reduced by the \$200,000 cumulative loss of the business, and owners' equity is now only \$300,000.
- 4 A business has \$175,000 total liabilities. Originally, at the time of starting the business, the owners invested \$250,000 capital. The business has earned \$190,000 cumulative profit since it started (all of which has been retained in the business). What is the total amount of its assets?

Total assets = \$615,000, which is the total of \$175,000 liabilities and \$440,000 owners' equity.

Notice that in addition to the original \$250,000 capital invested by owners, the business has earned \$190,000 profit, so its total owners' equity is \$440,000.
- 5 What would be the amount of accrual-basis sales revenue for the year if the business's year-end receivables had been \$92,000? (For the original numbers, see the section "Distinguishing Between Cash- and Accrual-Basis Accounting.")

Sales revenue (\$558,000 cash receipts + \$92,000 year-end receivables) = \$650,000
- 6 What would be the amount of accrual-basis cost of products sold expense for the year if the business's cost of products held in inventory at year-end had been \$95,000? (For the original numbers, see the section "Distinguishing Between Cash- and Accrual-Basis Accounting.")

Cost of products sold (\$375,000 cash payments – \$95,000 year-end inventory) = \$280,000

- 7 What would be the amount of accrual-basis other expenses for the year if the business's liability for unpaid expenses at year-end had been \$30,000? (For the original numbers, see the section "Distinguishing Between Cash- and Accrual-Basis Accounting.")

Other expenses (\$340,000 cash payments + \$30,000 year-end liability) = \$370,000

- 8 Based on the changes to the example given in Questions 5, 6, and 7, determine the profit or loss of the business for its first year.

In this case, the total of the two expenses (cost of products sold and other expenses) happens to be \$650,000, which is exactly equal to sales revenue. So, the business breaks even for the year. This outcome is unusual, of course; the total of expenses for the year is almost always different than total sales revenue for the year.

- 9 One rule of income statement reporting is that interest expense and income tax expense be reported separately. The \$10,010,000 "Other expenses" in the income statement for the answer to the example question includes \$350,000 interest expense and \$910,000 income tax. Rebuild the income statement given the information for these additional two expenses. Hint: Profit before interest expense is usually labeled "operating earnings," and profit after interest and before income tax expense is usually labeled "earnings before income tax."

Income Statement for Year

Sales revenue	\$26,000,000
Cost of goods sold	<u>14,300,000</u>
Gross margin	\$11,700,000
Other expenses	<u>8,750,000</u>
Operating earnings	\$2,950,000
Interest expense	<u>350,000</u>
Earnings before income tax	\$2,600,000
Income tax expense	<u>910,000</u>
Net income	\$1,690,000



REMEMBER

Burying interest expense or income tax expense in a broader expense category such as "other expenses" or "general expenses" is unacceptable. Interest and income tax expenses are reported toward the bottom of the income statement. They're viewed as nonoperating expenses, which means that they depend on how the business is financed and its income tax situation.

- 10 No specific rule governs income statement disclosure of advertising expense. Suppose the \$10,010,000 "Other expenses" in the income statement for the answer to the example question includes \$5,000,000 of advertising expense. Would you favor reporting this as a separate expense in the income statement? Hint: This question calls for your opinion only.

Well, there's no rule against disclosure of advertising expense — that's for sure. Because it's such a large expense, I favor disclosing it in the income statement. But most businesses are very sensitive about disclosing their advertising expense and, in fact, don't disclose this expense in their income statements.

- 11 No specific rule governs income statement disclosure of executive-level compensation for privately held businesses. For public companies, this is not the case as U.S. Securities and Exchange Commission (SEC) reporting generally requires the disclosure of executive salaries and other important and sensitive data (in Proxy statements and Form 10-K reporting).

Suppose the \$10,010,000 “Other expenses” in the income statement for the answer to the example question includes \$3,000,000 of executive-level compensation that includes both base salaries and generous bonuses. Would you favor reporting this as a separate expense in the income statement? Hint: This question calls for your opinion only.

Oh boy! This is a hot potato question. I’m all for open, frank, and transparent disclosure in financial reports, but this is like believing in Santa Claus. Most private businesses are very reluctant to disclose executive-level compensation in their income statements or elsewhere in their financial reports. With no rule forcing such disclosure in their income statements, most businesses don’t reveal this piece of information. You can ask for executive-level compensation information if you’re on the board of directors of the business, but as an outside shareowner, don’t expect to get this information.

- 12 Suppose the business distributed \$650,000 cash to its shareowners from its profit (net income) for the year. Is this cash disbursement treated as an expense?

No, cash distributions from profit to the shareowners of a business aren’t an expense. In other words, net income is before any distributions to shareowners.



TIP

Income statements generally don’t disclose information regarding distributions from profit (net income) during the year. To be more accurate, I should say that an income statement doesn’t have to disclose this information. However, some businesses don’t end their income statements at bottom-line net income: They add net income to the retained earnings balance at the start of the year and deduct distributions from net income during the year to arrive at the year-end balance of retained earnings. But such disclosure isn’t common practice. Distributions from net income usually are reported in a separate financial statement called the statement of changes in owners’ equity, which I discuss in Chapter 8.

- 13 Suppose \$950,000 of owners’ equity consists of profit earned and not distributed by the business. What is this amount usually called in the balance sheet? And, what is the other amount of owners’ equity called in the balance sheet?

The \$950,000 of owners’ equity over and above the amount of capital invested by the owners typically is called retained earnings. To be more precise, business corporations and limited liability companies use this term. (If a business is organized legally as a partnership or as a proprietorship, it follows different practices for reporting the owners’ equity.)

- 14 It appears that the business can’t pay its liabilities. The two liabilities total \$938,000, but the business has a cash balance of only \$396,000. Do you agree?

A business isn’t expected to hold cash equal to the total of its liabilities. In my opinion, this business wouldn’t be judged insolvent, although this judgment depends on how conservative or strict you are in evaluating solvency. The business’s cash flow prospects are the key factor. The accounts receivable will be collected in the short-run, and this incoming cash will be available for paying the business’s liabilities. The inventory held by the business will be sold during the short-run and will generate cash flow. Further, I don’t know when the Notes Payable becomes due; it may not be due for several months, by which time more sales and collections of receivables that are not yet on the balance sheet may be available to pay the Notes Payable.

- 15 Can you tell the amount of profit the business earned in the period just ended?

No, a balance sheet doesn’t report profit (net income) for the most recent period. You look to the income statement for this key figure.

- 16 In a balance sheet, assets usually are listed in the order of their “nearness” to cash. Cash is listed first, followed by the asset closest to being converted into cash, and so on. Is the sequence of assets according to normal rules for presenting assets in balance sheets?

Yes, the sequence is correct according to conventional rules for reporting assets in a balance sheet. Cash is listed first, followed by assets according to their “nearness” to cash. In the example, the business doesn’t have short-term investments in marketable securities. So, its accounts receivable asset is listed second, after cash, because these receivables will be collected in the short-term. Inventory is listed after accounts receivable because this asset consists of products that have to be sold before they can be converted into cash.

- 17 Based on the three of four components of cash flow for the year of a business that follow, determine the increase or decrease in cash during the year.

Cash flow from operating activities	\$450,000
Cash flow from investing activities	(\$725,000)
Cash flow from financing activities	<u>\$50,000</u>
Net increase (decrease) in cash during the year	????

Cash decreased \$225,000 during the year.

- 18 Based on the three of four components of cash flow for the year of a business that follow, determine cash flow from investing activities for the year.

Cash flow from operating activities	\$2,680,000
Cash flow from investing activities	????
Cash flow from financing activities	<u>\$1,250,000</u>
Net increase (decrease) in cash during the year	\$400,000

Cash flow from investing activities for the year is a negative \$3,530,000. In other words, the net cash decrease from investing activities was \$3,530,000 during the year.

- 19 Based on the three of four components of cash flow for the year of a business that follow, determine cash flow from financing activities for the year.

Cash flow from operating activities	\$650,000
Cash flow from investing activities	(\$925,000)
Cash flow from financing activities	<u>_____</u> ????
Net increase (decrease) in cash during the year	(\$65,000)

Cash flow from financing activities for the year is \$210,000. In other words, the net cash increase from financing activities was \$210,000 during the year.

- 20 Based on the three of four components of cash flow for the year of a business that follow, determine cash flow from operating activities for the year.

Cash flow from operating activities	????
Cash flow from investing activities	(\$480,000)
Cash flow from financing activities	<u>(\$150,000)</u>
Net increase (decrease) in cash during the year	\$150,000

Cash flow from operating activities for the year is \$780,000. In other words, the net cash increase from sales and expense (operating) activities was \$780,000 during the year.

- 21 Suppose a business commits accounting fraud by deliberately not reducing the cost of its inventory by \$268,000, which is the cost of certain products that are obsolete, can no longer be sold, and will be thrown in the junk heap. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects?

The changes in the balance sheet to correct the fraudulent error are:

Cash		Accounts Payable	
Accounts Receivable		Notes Payable	
Inventory	(\$268,000)	Owners' Equity	(\$268,000)
Fixed Assets (Net of Accumulated Depreciation)	_____		_____
Total Assets	(\$268,000)	Total Liabilities and Owners' Equity	(\$268,000)

- 22 Suppose a business commits accounting fraud by deliberately not recording \$465,000 of liabilities for unpaid expenses at the end of the year. How should its balance sheet be adjusted to correct for this accounting fraud, ignoring income tax effects?

The changes in the balance sheet to correct the fraudulent error are:

Cash		Accounts Payable	\$465,000
Accounts Receivable		Notes Payable	
Inventory		Owners' Equity	(\$465,000)
Fixed Assets (Net of Accumulated Depreciation)	_____		_____
Total Assets		Total Liabilities and Owners' Equity	