cHAPTER 1

Introducing Financial statements

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

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

***SP refers to the Serial Problem***

***FSA refers to Financial Statement Analysis***

***BTN refers to Beyond the Numbers***

# Additional Information on Related Assignment Material

**Connect**

Available on the instructor’s course-specific website, Connect repeats all numerical Quick Studies, all Exercises, and Problem Set A. Connect also provides algorithmic versions for Quick Study, Exercises, and Problems. It allows instructors to monitor, promote, and assess student learning. It can be used in practice, homework, or exam mode.

**Connect Insight**

The first and only analytics tool of its kind, Connect Insight is a series of visual data displays that are each framed by an intuitive question and provide at-a-glance information regarding how an instructor’s class is performing. Connect Insight is available through Connect titles.

**General Ledger**

Assignable within Connect, General Ledger (GL) problems offer students the ability to see how transactions post from the general journal all the way through the financial statements. Critical thinking and analysis components are added to each GL problem to ensure understanding of the entire process. GL problems are auto-graded and provide instant feedback to the student.

**Excel Simulations**

Assignable within Connect, Excel Simulations allow students to practice their Excel skills—such as basic formulas and formatting—within the context of accounting. These questions feature animated, narrated Help and Show Me tutorials (when enabled). Excel Simulations are auto-graded and provide instant feedback to the student.

# Synopsis of Chapter Revisions

* Updated opener—**Apple** and entrepreneurial assignment.
* Updated salary info for accountants.
* Reorganized “Ethics” section to include enforcing ethics.
* Streamlined the “Fundamentals of Accounting” section.
* Streamlined the “International Standards” section.
* Revised the business entity discussion along with adding LLC.
* Updated the section on revenue recognition.
* Updated section on accounting constraints.
* New layout for introducing financial statements.
* Updated **Apple** numbers for NTK 1-5.
* Global View moved to follow assignments – for all chapters.
* Updated Social Index graph for sustainable investing in Decision Insights.
* New company, **Nike**, and data for Decision Analysis section.
* Added two new Exercise assignments.
* Added new analysis assignments: Financial Analysis, Comparative Analysis, and Global Analysis.

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

|  |  |
| --- | --- |
| Chapter Outline | Notes |
| 1. Internal Controls—procedures to protect company property and equipment and ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies. Congress passed the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act to help enforce ethics at publicly traded companies.   B. Generally Accepted Accounting Principles (GAAP)—concepts and rules that govern financial accounting. The purpose of GAAP is to make information in accounting statements relevant, reliable, and comparable. |  |
| 1. Setting Accounting Principles |  |
| a. In the U.S. the major rule-setting bodies are the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB). The SEC delegated the authority to set U.S. GAAP to the FASB. |  |
| C. International Standards—The International Accounting Standards Board (IASB) issues standards (International Financial Reporting Standards, or IFRS) that identify preferred accounting practices in the global economy. IFRS are similar but sometimes different from U.S. GAAP.  1. Differences between U.S. GAAP and IFRS are decreasing as the FASB and IASB pursue a process to reduce inconsistencies. |  |
| 1. Conceptual Framework—FASB Conceptual Framework consists of: |  |
| 1. Objectives—to provide information useful to investors, creditors, and others. 2. Qualitative Characteristics—to require information that is relevant, reliable, and comparable. 3. Elements—to define items that financial statements can contain. 4. Recognition and Measurement—to set criteria that an item must meet for it to be recognized as an element; and how to measure that element. |  |
| 1. Principles and Assumptions of Accounting—two types are *general principles* (assumptions, concepts, and guidelines for preparing financial statements; stem from long-used accounting practices) and *specific principles* (detailed rules used in reporting transactions and events).  a. Accounting Principles—General principles consist of at  least four basic principles discussed in this chapter: |  |

|  |  |
| --- | --- |
| Chapter Outline | Notes |
| 1. *Measurement principle (also called the cost principle)*—financial statements are based on actual costs (with possible later adjustments to market) incurred in business transactions. Cost is measured on a cash or equal-to-cash basis. Information based on cost is considered objective. *Objectivity* means information is supported by independent, unbiased evidence. |  |
| 1. *Revenue recognition principle*—revenue is recognized (recorded) (1) when goods or services are provided to customers and (2) at the amount expected to be received from the customer. 2. *Expense recognition principle (also called the matching principle)*—prescribes that a company record expenses it incurred to generate revenues it reported. 3. *Full disclosure principle*—prescribes reporting the details behind the financial statements that would impact users’ decisions; often in footnotes to the statements. |  |
| b. Accounting Assumptions—The four assumptions discussed in this chapter are:  i. *Going-concern assumption*—accounting information presumes that the business will continue operating instead of being closed or sold.  ii. *Monetary unit assumption*—transactions and events are expressed in monetary, or money, units. Generally this is the currency of the country in which it operates, but today some companies express reports in more than one monetary unit. |  |
| iii. *Time period assumption*—the life of the company can be divided into time periods, such as months and years, and useful reports can be prepared for those periods. |  |
| iv. *Business entity assumption*—a business is accounted for separately from other business entities and its owner. Necessary for good decisions |  |
| c. Exhibit 1.8: Types and Attributes of Businesses |  |
| * + 1. *Sole proprietorship* is a business owned by one person that has unlimited liability. It is not a separate legal entity. The owner has unlimited liability and is, therefore, personally liable for the business debts. |  |
| Chapter Outline | Notes |
| * + 1. *Partnership* is a business owned by two or more people, called partners, who aresubject to unlimited liability. The business is not subject to an income tax, but the owners are responsible for personal income tax on their individual share of the net income of entity. |  |
| * + 1. *Limited Liability Company (LLC)* is a business owned by one or more members. It offers limited liability to the members who are not personally liable for the debts of the LLC, and is a separate entity with the same rights and responsibilities as a person. |  |
| * + 1. *Corporation* is a business that is a separate legal entity whose owners are called shareholders or stockholders. These owners have limited liability. The entity is responsible for a business income tax, and the owners are responsible for personal income tax on profits that are distributed to them in the form of dividends. |  |
| 1. Accounting Constraints   There are basic constraints on financial reporting. |  |
| 1. The *cost-benefit* constraint prescribes that only information with benefits of disclosure greater than the costs of providing it needs be disclosed. 2. The *materiality* constraint is the ability of information to influence decisions. 3. *Conservatism* and *industry practices* are sometimes referred to as constraints as well. |  |
| **III. Business Transactions and Accounting** |  |
| A. Accounting Equation (Assets = Liabilities + Equity)—elements of the equation include: |  |
| 1. Assets—resources a company owns or controls that are expected to carry future benefits (i.e., cash, supplies, equipment, and land).  2. Liabilities—creditors’ claims on assets. These claims reflect obligations to transfer assets or provide products or services to others.  3. Equity—owner’s claim on assets; assets minus liabilities. Also called *net assets* or *residual equity.* Changes in equity result from common stock, revenues, dividends, and expenses.   1. Common stock —part of contributed capital, reflects inflows of resources such as cash and other assets from stockholders in exchange for stock; results in an increase in equity. |  |
| Chapter Outline | Notes |
| 1. Revenues—increase equity from sales of products and services to customers. Revenues increase equity (via net income) and result from a company’s earnings activities. |  |
| 1. Dividends—outflows of resources such as cash and other assets to stockholders. Dividends decrease equity. 2. Expenses—cost of assets or services used to earn revenues Expenses decrease equity. |  |
| 1. Expanded Accounting Equation:   Assets = Liabilities + Common Stock − Dividends + Revenues − Expenses. Net income occurs when revenues exceed expenses. Net income increases equity. A net loss occurs when expenses exceed revenues, which decreases equity. |  |
| 1. Transaction Analysis—each transaction and event always leaves the equation in balance. (Assets = Liabilities + Equity) |  |
| 1. Investment by owner in exchange for common stock:   ASSET = LIABILITIES + EQUITY  **+ Cash + Common Stock**   *reason: investment*  Increase on both sides of equation keeps equation in balance.   1. Purchase supplies for cash:   ASSET = LIABILITIES + EQUITY **+ Supplies**  **− Cash** Increase and decrease on one side of the equation keeps equation in balance.   1. Purchase equipment for cash:   ASSET = LIABILITIES + EQUITY **+ Equipment**  **– Cash** Increase and decrease on one side of the equation keeps equation in balance.   1. Purchase supplies on credit:   ASSET = LIABILITIES + EQUITY **+ Supplies + Accounts Payable**  Increase on both sides of equation keeps equation in balance.   1. Provide services for cash:  ASSET = LIABILITIES + EQUITY **+ Cash + Revenue Earned** Increase on both sides of equation keeps equation in balance. |  |
| Chapter Outline | Notes |
| 6,7. Payment of expenses in cash (salaries, rent, etc.):  ASSET = LIABILITIES + EQUITY **− Cash − (+ Expense)**  Decrease on both sides of equation keeps equation in balance.  8. Provided services and facilities for credit:  ASSET = LIABILITIES + EQUITY **+ Acct. Rec. + Revenue Earned**  Increase on both sides of equation keeps equation in balance.  9. Receipt of cash from accounts receivable (customers paying on their accounts):  ASSET = LIABILITIES + EQUITY  **+ Cash**  **− Acct. Rec**  Increase and decrease on one side of the equation keeps equation in balance. |  |
| 10. Payment of accounts payable:  ASSET = LIABILITIES + EQUITY  **− Cash − Accounts Payable**  Decrease on both sides of equation keeps equation in balance. |  |
| 11. Payment of cash dividend:  ASSET = LIABILITIES + EQUITY  **− Cash − (+ Dividends)**  Decrease on both sides of equation keeps equation in balance. (Note: since dividends are not expenses, they are not used in computing net income.) |  |

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

|  |  |
| --- | --- |
| Chapter Outline | Notes |
| |  | | --- | | **V. Sustainability and Accounting — The Sustainability Accounting Standards Board** (SASB) is a nonprofit entity engaged in creating and disseminating sustainability accounting standards for companies. | | 1. Sustainability—refers to environmental, social and governance aspects. Includes social aspects such as donations and environmental aspects such as reducing pollution and increasing safety. 2. Sustainability Returns—returns for companies with sustainable behavior are roughly on par with or better than those of S&P 500 companies. | | **VI. Decision Analysis—Return on Assets (ROA)—**a profitability measure. Also called Return on Investment (ROI). | | A. Useful in evaluating management, analyzing and forecasting profits, and planning activities.  B. The return on assets is calculated by dividing net income for a period by average total assets. (Average total assets is determined by adding the beginning and ending assets and dividing by 2.)  C. As with all analysis tools, results should be compared to previous business results as well as competitor’s results and industry norms. | | **VII.** **Return and Risk (Appendix 1A)** | | A. Risk—the uncertainty about the return we will earn on an investment.  B. The lower the risk, the lower the return.  C. Higher risk implies higher, but riskier, returns. |   **VIII.** **Business Activities (Appendix 1B)** |  |
| The accounting equation is derived from business activities.  Three major business activities are: |  |
| 1. Financing activities—activities that provide the means organizations use to pay for resources such as land, buildings, and equipment to carry out plans. Two types of financing are: |  |
| a. Owner financing—refers to resources contributed by owner including income left in the organization.  b. Nonowner (or creditor) financing—refers to resources loaned by creditors (lenders). |  |
| 2. Investing activities—are the acquiring and disposing of resources (assets) that an organization uses to acquire and sell its products or services.   1. Investing (assets) is balanced by Financing (liabilities and equity). Operating activities are the result of investing and financing.   3. Operating activities—involve using resources to research, develop, purchase, produce, distribute, and market products and services. |  |
|  |  |

# VISUAL #1-1

## WARNING: NO MATTER WHAT HAPPENS

## ALWAYS KEEP THIS SCALE

## IN BALANCE



## Basic Accounting Equation

## ASSETS = LIABILITIES + EQUITY

## TRANSACTION ANALYSIS RULES

1) Every transaction affects at least two items.

2) Every transaction must result in a balanced equation.

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