

A Look at This Chapter

Accounting is crucial in our information age. In this chapter, we discuss the importance of accounting to different types of organizations and describe its many users and uses. We explain that ethics are essential to accounting. We also explain business transactions and how they are reflected in financial statements.

A Look Ahead

Chapter 2 describes and analyzes business transactions. We explain the analysis and recording of transactions, the ledger and trial balance, and the double-entry system. More generally, Chapters 2 and 3 show (via the accounting cycle) how financial statements reflect business activities.

1

Introducing Accounting in Business

Learning Objectives

Learning Objectives are classified as conceptual, analytical, or procedural.

CAP

CONCEPTUAL

- C1** Explain the purpose and importance of accounting. (p. 4)
- C2** Identify users and uses of, and opportunities in, accounting. (p. 5)
- C3** Explain why ethics are crucial to accounting. (p. 8)
- C4** Explain generally accepted accounting principles and define and apply several accounting principles. (p. 9)
- C5** *Appendix 1B*—Identify and describe the three major activities of organizations. (p. 28)

ANALYTICAL

- A1** Define and interpret the accounting equation and each of its components. (p. 15)
- A2** Compute and interpret return on assets. (p. 24)
- A3** *Appendix 1A*—Explain the relation between return and risk. (p. 28)



LPI

PROCEDURAL

- P1** Analyze business transactions using the accounting equation. (p. 16)
- P2** Identify and prepare basic financial statements and explain how they interrelate. (p. 20)



Decision Insight



Accounting for Twitter

A **Decision Feature** launches each chapter showing the relevance of accounting for a real entrepreneur. An **Entrepreneurial Decision** problem at the end of the assignments returns to this feature with a mini-case. "There is so much going on here . . ."

—BIZ STONE (RIGHT)

SAN FRANCISCO—"We came across the word 'twitter,' and it was just perfect," recalls Jack Dorsey (center of photo). "The definition was 'a short burst of inconsequential information,' and 'chirps from birds,' and that's exactly what the product was." Today, Twitter boasts over 200 million users. Founded by Jack, along with Biz Stone (right) and Evan Williams (left), **Twitter (Twitter.com)** is "facilitating connections between businesses and individuals in meaningful and relevant ways," says Jack. Along the way, the young entrepreneurs had to learn accounting and the details of preparing and interpreting financial statements.

"There is so much going on here," explains Biz when describing Twitter's business model. However, admits Evan, "We did a poor job of communicating." Important questions involving business formation, transaction analysis, and financial reporting arose. The entrepreneurs eventually met those challenges and, in the process, set Twitter apart. "If you stand pat," says Evan, "you risk being stagnant."

Information is the focus within Twitter's accounting records and systems. Jack recalls that when they launched Twitter, there were all these reasons why they would not succeed. He applied their similar "can-do" approach to accounting information. "My whole philosophy is making tech [and accounting] more accessible and human," says Jack. This includes using accounting information to make key business decisions.

Twitter is the language of micro-blogging, and accounting is the language of business. "Twitter is so many things: a messaging service, a customer-service tool, a real-time search," explains Biz, and the

accounting system had to capture those things. Biz adds that Twitter is exploring additional "interesting ways to generate revenue." That revenue-stream is reflected in its financial statements, which are based on transaction analysis and accounting concepts.

Twitter's revenues exhibit growth and reflect what experts call the *monetizing* of its business. A recent study by the marketing firm SocialTwist found that the click-through rate was 19 for Twitter, which is the number of clicks on an embedded link. This compares with 3 clicks for Facebook links. Twitter's revenues in the recent year were estimated at \$45 million, which are projected to exceed \$100 million next year. Twitter also tracks its expenses and asset purchases. Twitter owners have an estimated valuation of between \$5 and \$10 billion!

The three entrepreneurs emphasize that accounting records must be in order for Twitter to realize its full potential. Many experts predict a public offering of its stock within the next two years, which could generate untold wealth. Still, Evan recognizes that "so many people here [at Twitter] contribute to that success." He also emphasizes that learning is a key to their business success. "I realized," insists Evan, "I could buy books and learn something that people spent years learning."

[Sources: Twitter Website, January 2012; *Entrepreneur*, December 2010; *USA Today*, May 2009; Smedio.com, June 2011; *San Francisco Chronicle*, March 2011; SocialTwist.com, October 2010; *The Wall Street Journal*, February 2011]

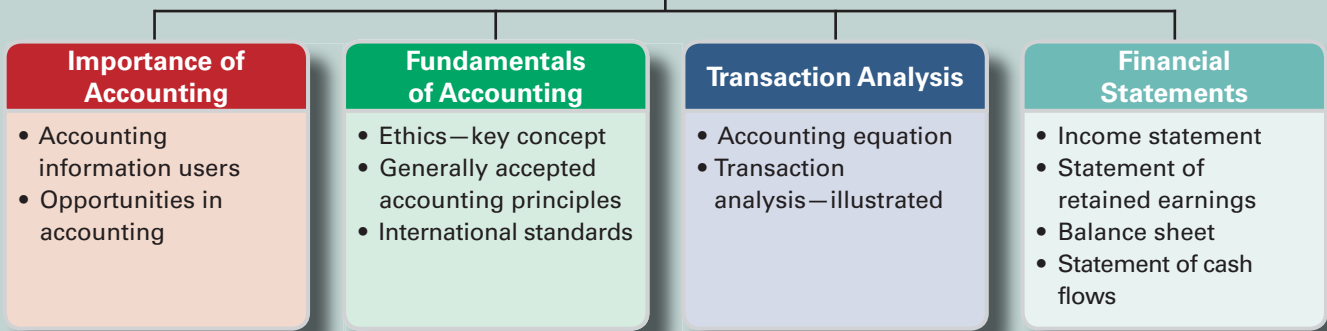
Chapter Preview

A Preview opens each chapter with a summary of topics covered.

Today's world is one of information—its preparation, communication, analysis, and use. Accounting is at the core of this information age. Knowledge of accounting gives us career opportunities and the insight to take advantage of them. This book introduces concepts, procedures, and analyses that help

us make better decisions, including career choices. In this chapter we describe accounting, the users and uses of accounting information, the forms and activities of organizations, and several accounting principles. We also introduce transaction analysis and financial statements.

Introducing Accounting in Business



IMPORTANCE OF ACCOUNTING

C1 Explain the purpose and importance of accounting.

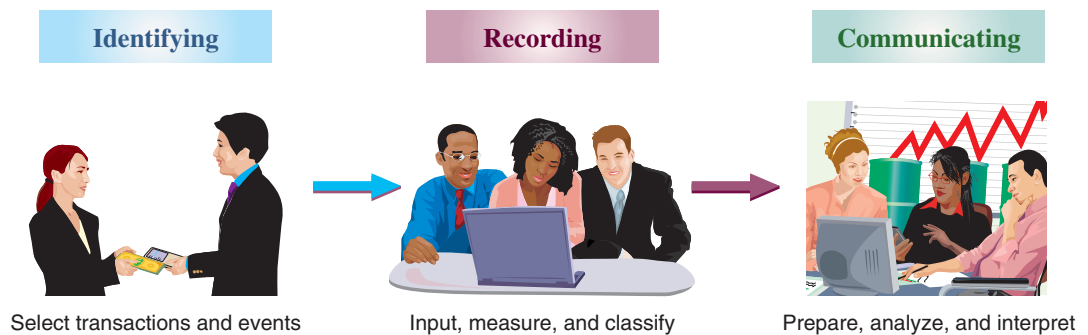
Why is accounting so popular on campuses? Why are there so many accounting jobs for graduates? Why is accounting so important to companies? Why do politicians and business leaders focus on accounting regulations? The answer is that we live in an information age, where that information, and its reliability, impacts the financial well-being of us all.

Accounting is an information and measurement system that identifies, records, and communicates relevant, reliable, and comparable information about an organization's business activities. *Identifying* business activities requires selecting transactions and events relevant to an organization. Examples are the sale of iPhones by **Apple** and the receipt of ticket money by **TicketMaster**. *Recording* business activities requires keeping a chronological log of transactions and events measured in dollars and classified and summarized in a useful format. *Communicating* business activities requires preparing accounting reports such as financial statements. It also requires analyzing and interpreting such reports. (The financial statements and notes of **Research In Motion**, the maker of BlackBerry, are shown in Appendix A near the end of this book. This appendix also shows the financial statements of **Apple**, **Palm**, and **Nokia**.) Exhibit 1.1 summarizes accounting activities.

Real company names are printed in bold magenta.

We must guard against a narrow view of accounting. Our most common contact with accounting is through credit approvals, checking accounts, tax forms, and payroll. These experiences are limited and tend to focus on the recordkeeping parts of accounting. **Recordkeeping**, or **bookkeeping**, is the recording of transactions and events, either manually or electronically. This is just one part of accounting. Accounting also identifies and communicates information on transactions and events, and it includes the crucial processes of analysis and interpretation.

EXHIBIT 1.1
Accounting Activities





Technology is a key part of modern business and plays a major role in accounting. Technology reduces the time, effort, and cost of recordkeeping while improving clerical accuracy. Some small organizations continue to perform various accounting tasks manually, but even they are impacted by technology. As technology has changed the way we store, process, and summarize masses of data, accounting has been freed to expand. Consulting, planning, and other financial services are now closely linked to accounting. These services require sorting through data, interpreting their meaning, identifying key factors, and analyzing their implications.

Point: Technology is only as useful as the accounting data available, and users' decisions are only as good as their understanding of accounting. The best software and recordkeeping cannot make up for lack of accounting knowledge.

Margin notes further enhance the textual material.

Users of Accounting Information

Accounting is often called the *language of business* because all organizations set up an accounting information system to communicate data to help people make better decisions. Exhibit 1.2 shows that the accounting information system serves many kinds of users (this is a partial listing) who can be divided into two groups: external users and internal users.

External users



- Lenders
- Consumer groups
- Shareholders
- External auditors
- Governments
- Customers

Internal users



- Officers
- Sales staff
- Managers
- Budget officers
- Internal auditors
- Controllers

EXHIBIT 1.2

Users of Accounting Information

Infographics reinforce key concepts through visual learning.

External Information Users External users of accounting information are *not* directly involved in running the organization. They include shareholders (investors), lenders, directors, customers, suppliers, regulators, lawyers, brokers, and the press. External users have limited access to an organization's information. Yet their business decisions depend on information that is reliable, relevant, and comparable.

Financial accounting is the area of accounting aimed at serving external users by providing them with *general-purpose financial statements*. The term *general-purpose* refers to the broad range of purposes for which external users rely on these statements.

Each external user has special information needs depending on the types of decisions to be made. *Lenders* (creditors) loan money or other resources to an organization. Banks, savings and loans, co-ops, and mortgage and finance companies are lenders. Lenders look for information to help them assess whether an organization is likely to repay its loans with interest. *Shareholders* (investors) are the owners of a corporation. They use accounting reports in deciding whether to buy, hold, or sell stock. Shareholders typically elect a *board of directors* to oversee their interests in an organization. Since directors are responsible to shareholders, their information needs are similar. *External* (independent) *auditors* examine financial statements to verify that they are prepared according to generally accepted accounting principles. *Nonexecutive employees* and *labor unions* use financial statements to judge the fairness of wages, assess job prospects, and bargain for better wages. *Regulators* often have legal authority over certain activities of organizations. For example, the Internal Revenue Service (IRS) and other tax authorities require organizations to file accounting reports in computing taxes. Other regulators include utility boards that use accounting information to set utility rates and securities regulators that require reports for companies that sell their stock to the public.

Accounting serves the needs of many other external users. *Voters*, *legislators*, and *government officials* use accounting information to monitor and evaluate government receipts and expenses. *Contributors* to nonprofit organizations use accounting information to evaluate the use and impact of their donations. *Suppliers* use accounting information to judge the soundness

C2 Identify users and uses of, and opportunities in, accounting.



of a customer before making sales on credit, and *customers* use financial reports to assess the staying power of potential suppliers.

Internal Information Users Internal users of accounting information are those directly involved in managing and operating an organization. They use the information to help improve the efficiency and effectiveness of an organization. **Managerial accounting** is the area of accounting that serves the decision-making needs of internal users. Internal reports are not subject to the same rules as external reports and instead are designed with the special needs of internal users in mind.

There are several types of internal users, and many are managers of key operating activities. *Research and development managers* need information about projected costs and revenues of any proposed changes in products and services. *Purchasing managers* need to know what, when, and how much to purchase. *Human resource managers* need information about employees' payroll, benefits, performance, and compensation. *Production managers* depend on information to monitor costs and ensure quality. *Distribution managers* need reports for timely, accurate, and efficient delivery of products and services. *Marketing managers* use reports about sales and costs to target consumers, set prices, and monitor consumer needs, tastes, and price concerns. *Service managers* require information on the costs and benefits of looking after products and services. Decisions of these and other internal users depend on accounting reports.

Both internal and external users rely on internal controls to monitor and control company activities. *Internal controls* are procedures set up to protect company property and equipment, ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies. Examples are good records, physical controls (locks, passwords, guards), and independent reviews.

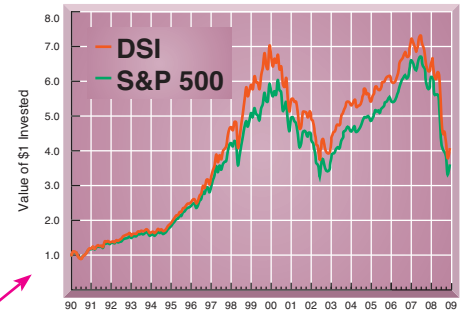
Decision Insight boxes highlight relevant items from practice.

Decision Insight



Virtuous Returns Virtue is not always its own reward. Compare the S&P 500 with the Domini Social Index (DSI), which covers 400 companies that have especially good records of social responsibility. We see that returns for companies with socially responsible behavior are at least as high as those of the S&P 500. ■

Copyright © 2010 by KLD Research & Analytics, Inc. The "FTSE KLD 400 Social Index" is a service mark of KLD Research & Analytics.



Graphical displays are often used to illustrate key points.

Opportunities in Accounting

Accounting information affects many aspects of our lives. When we earn money, pay taxes, invest savings, budget earnings, and plan for the future, we are influenced by accounting. Accounting has four broad areas of opportunities: financial, managerial, taxation, and accounting-related. Exhibit 1.3 lists selected opportunities in each area.

EXHIBIT 1.3

Accounting Opportunities





The majority of accounting opportunities are in *private accounting*, which are employees working for businesses, as shown in Exhibit 1.4. *Public accounting* offers the next largest number of opportunities, which involve services such as auditing and tax advice to a vast range of businesses. Still other opportunities exist in government and not-for-profit agencies, including business regulation and investigation of law violations.

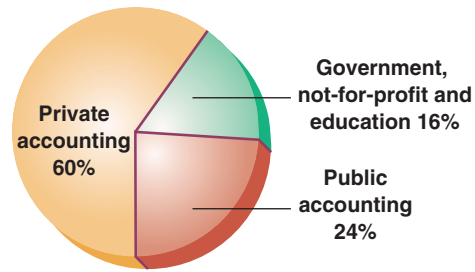


EXHIBIT 1.4

Accounting Jobs by Area

Accounting specialists are highly regarded and their professional standing is often denoted by a certificate. Certified public accountants (CPAs) must meet education and experience requirements, pass an examination, and exhibit ethical character. Many accounting specialists hold certificates in addition to or instead of the CPA. Two of the most common are the certificate in management accounting (CMA) and the certified internal auditor (CIA). Employers also look for specialists with designations such as certified bookkeeper (CB), certified payroll professional (CPP), personal financial specialist (PFS), certified fraud examiner (CFE), and certified forensic accountant (CrFA).

Individuals with accounting knowledge are always in demand as they can help with financial analysis, strategic planning, e-commerce, product feasibility analysis, information technology, and financial management. Benefit packages can include flexible work schedules, telecommuting options, career path alternatives, casual work environments, extended vacation time, and child and elder care.

Demand for accounting specialists is strong. Exhibit 1.5 reports average annual salaries for several accounting positions. Salary variation depends on location, company size, professional designation, experience, and other factors. For example, salaries for chief financial officers (CFO) range from under \$75,000 to more than \$1 million per year. Likewise, salaries for bookkeepers range from under \$30,000 to more than \$80,000.

Point: The largest accounting firms are Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers.

Point: Census Bureau (2009) reports that for workers 18 and over, higher education yields higher average pay:

Advanced degree	\$80,977
Bachelor's degree	57,181
High school degree	31,286
No high school degree	21,484

Field	Title (experience)	2010 Salary	2015 Estimate*
Public Accounting	Partner	\$191,000	\$211,000
	Manager (6–8 years)	94,500	104,000
	Senior (3–5 years)	72,000	79,500
	Junior (0–2 years)	51,500	57,000
Private Accounting	CFO	232,000	256,000
	Controller/Treasurer	147,500	163,000
	Manager (6–8 years)	87,500	96,500
	Senior (3–5 years)	72,500	80,000
Recordkeeping	Junior (0–2 years)	49,000	54,000
	Full-charge bookkeeper	57,500	63,500
	Accounts manager	51,000	56,500
	Payroll manager	54,500	60,000
	Accounting clerk (0–2 years)	37,500	41,500

EXHIBIT 1.5

Accounting Salaries for Selected Fields

* Estimates assume a 2% compounded annual increase over current levels (rounded to nearest \$500).

Point: For updated salary information: Abbott-Langer.com, www.AICPA.org, Kforce.com

Quick Check Answers — p. 30

1. What is the purpose of accounting?
2. What is the relation between accounting and recordkeeping?
3. Identify some advantages of technology for accounting.
4. Who are the internal and external users of accounting information?
5. Identify at least five types of managers who are internal users of accounting information.
6. What are internal controls and why are they important?

Quick Check is a chance to stop and reflect on key points.

Point: U.S. Bureau of Labor (June 2011) reports higher education results in less unemployment:

Bachelor's degree or more	4.4%
High school degree	10.0%
No high school degree	14.3%



FUNDAMENTALS OF ACCOUNTING

Accounting is guided by principles, standards, concepts, and assumptions. This section describes several of these key fundamentals of accounting.

Ethics—A Key Concept

C3 Explain why ethics are crucial to accounting.

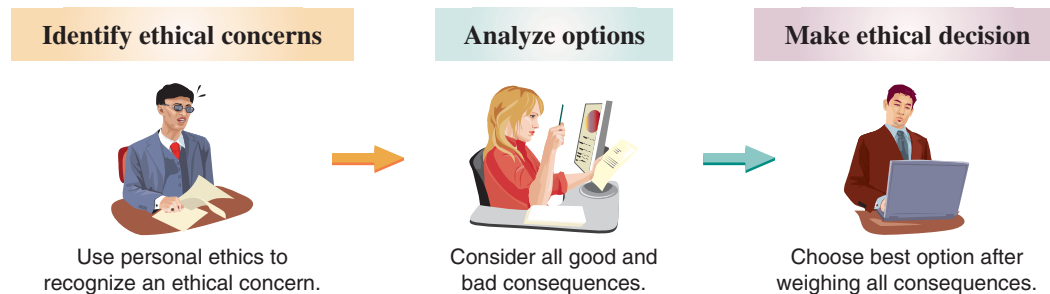
Point: Sarbanes-Oxley Act requires each issuer of securities to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of that code.

The goal of accounting is to provide useful information for decisions. For information to be useful, it must be trusted. This demands ethics in accounting. **Ethics** are beliefs that distinguish right from wrong. They are accepted standards of good and bad behavior.

Identifying the ethical path is sometimes difficult. The preferred path is a course of action that avoids casting doubt on one's decisions. For example, accounting users are less likely to trust an auditor's report if the auditor's pay depends on the success of the client's business. To avoid such concerns, ethics rules are often set. For example, auditors are banned from direct investment in their client and cannot accept pay that depends on figures in the client's reports. Exhibit 1.6 gives guidelines for making ethical decisions.

EXHIBIT 1.6

Guidelines for Ethical Decision Making



Providers of accounting information often face ethical choices as they prepare financial reports. These choices can affect the price a buyer pays and the wages paid to workers. They can even affect the success of products and services. Misleading information can lead to a wrongful closing of a division that harms workers, customers, and suppliers. There is an old saying: *Good ethics are good business.*

Some people extend ethics to *social responsibility*, which refers to a concern for the impact of actions on society. An organization's social responsibility can include donations to hospitals, colleges, community programs, and law enforcement. It also can include programs to reduce pollution, increase product safety, improve worker conditions, and support continuing education. These programs are not limited to large companies. For example, many small businesses offer discounts to students and senior citizens. Still others help sponsor events such as the Special Olympics and summer reading programs.

Point: The American Institute of Certified Public Accountants' *Code of Professional Conduct* is available at www.AICPA.org.

Fraud Triangle



The fraud triangle is a model created by a criminologist, which asserts the following *three* factors must exist for a person to commit fraud: opportunity, pressure, and rationalization.

Opportunity is one side of the fraud triangle. A person must envision a way to commit fraud with a low perceived risk of getting caught. Employers can directly reduce this risk. An example of some control on opportunity is a pre-employment background check. *Pressure*, or incentive, is another side of the fraud triangle. A person must be motivated to commit fraud. Examples are unpaid bills and addictions. *Rationalization*, or attitude, is the third side of the fraud triangle. A person who rationalizes fails to see the criminal nature of the fraud or justifies the action.

The key to dealing with fraud is to focus on prevention. It is cheaper and more effective to prevent fraud from happening than it is to try to detect the crime. By the time the fraud is discovered, the money is gone and chances are slim to none that it will be recovered. Additionally, it is costly and time consuming to investigate a fraud.

It is important to recognize that all three factors of the fraud triangle must usually exist for fraud to occur. The absence of one or more factors suggests fraud is unlikely. When we focus on



fraud prevention, it almost always involves reducing opportunity. It is generally less costly to prevent fraud than to cover losses from fraud.



Fraud

They Fought the Law Our economic and social welfare depends on reliable accounting. Some individuals forgot that and are now paying their dues. They include Bernard Madoff (in photo) of **Madoff Investment Securities**, convicted of falsifying securities records; Bernard Ebbers of **WorldCom**, convicted of an \$11 billion accounting scandal; Andrew Fastow of **Enron**, guilty of hiding debt and inflating income; and Ramalinga Raju of **Satyam Computers**, accused of overstating assets by \$1.5 billion.



Generally Accepted Accounting Principles

Financial accounting practice is governed by concepts and rules known as **generally accepted accounting principles (GAAP)**. To use and interpret financial statements effectively, we need to understand these principles, which can change over time in response to the demands of users. GAAP aims to make information in financial statements *relevant, reliable, and comparable*. Relevant information affects the decisions of its users. Reliable information is trusted by users. Comparable information is helpful in contrasting organizations.

In the United States, the **Securities and Exchange Commission (SEC)**, a government agency, has the legal authority to set GAAP. The SEC also oversees proper use of GAAP by companies that raise money from the public through issuances of their stock and debt. Those companies that issue their stock on U.S. exchanges include both *U.S. SEC registrants* (companies incorporated in the United States) and *non-U.S. SEC registrants* (companies incorporated under non-U.S. laws). The SEC has largely delegated the task of setting U.S. GAAP to the **Financial Accounting Standards Board (FASB)**, which is a private-sector group that sets both broad and specific principles.

International Standards

In today's global economy, there is increased demand by external users for comparability in accounting reports. This demand often arises when companies wish to raise money from lenders and investors in different countries. To that end, the **International Accounting Standards Board (IASB)**, an independent group (consisting of individuals from many countries), issues **International Financial Reporting Standards (IFRS)** that identify preferred accounting practices.

If standards are harmonized, one company can potentially use a single set of financial statements in all financial markets. Differences between U.S. GAAP and IFRS are slowly fading as the FASB and IASB pursue a *convergence* process aimed to achieve a single set of accounting standards for global use. More than 115 countries now require or permit companies to prepare financial reports following IFRS. Further, non-U.S. SEC registrants can use IFRS in financial reports filed with the SEC (with no reconciliation to U.S. GAAP). This means there are *two* sets of accepted accounting principles in the United States: (1) U.S. GAAP for U.S. SEC registrants and (2) either IFRS or U.S. GAAP for non-U.S. SEC registrants.

The convergence process continues and the SEC has set a roadmap for use of IFRS by publicly traded U.S. companies. This roadmap tentatively proposes that large U.S. companies adopt IFRS by 2014, with midsize and small companies following in 2015 and 2016, respectively. Early adoption is permitted for large multinationals that meet certain criteria. For updates on this roadmap, we can check with the AICPA (IFRS.com), FASB (FASB.org), and IASB (IASB.org.uk).



IFRS

Like the FASB, the IASB uses a conceptual framework to aid in revising or drafting new standards. However, unlike the FASB, the IASB's conceptual framework is used as a reference when specific guidance is lacking. The IASB also requires that transactions be accounted for according to their substance (not only their legal form), and that financial statements give a fair presentation, whereas the FASB narrows that scope to fair presentation *in accordance with U.S. GAAP*. ●

C4 Explain generally accepted accounting principles and define and apply several accounting principles.

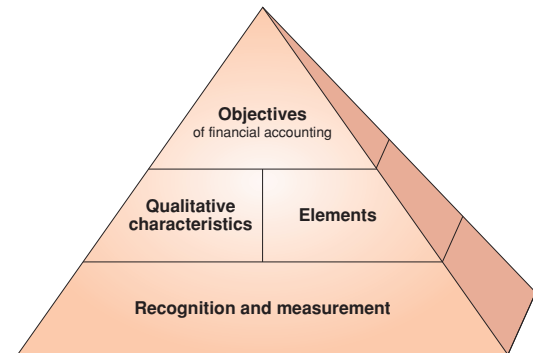
Point: State ethics codes require CPAs who audit financial statements to disclose areas where those statements fail to comply with GAAP. If CPAs fail to report noncompliance, they can lose their licenses and be subject to criminal and civil actions and fines.



Conceptual Framework and Convergence

The FASB and IASB are attempting to converge and enhance the **conceptual framework** that guides standard setting. The framework consists broadly of the following:

- **Objectives**—to provide information useful to investors, creditors, and others.
- **Qualitative characteristics**—to require information that is relevant, reliable, and comparable.
- **Elements**—to define items that financial statements can contain.
- **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.



For updates on this joint FASB and IASB conceptual framework convergence we can check with FASB.org or IASB.org.uk Websites. We must remember that U.S. GAAP and IFRS are two similar, but not identical, systems. However, their similarities greatly outweigh any differences. The remainder of this section describes key principles and assumptions of accounting.

Decision Insight



Principles and Scruples Auditors, directors, and lawyers are using principles to improve accounting reports. Examples include accounting restatements at **Navistar**, financial restatements at **Nortel**, accounting reviews at **Echostar**, and expense adjustments at **Electronic Data Systems**. Principles-based accounting has led accounting firms to drop clients deemed too risky. Examples include **Grant Thornton**'s resignation as auditor of **Fremont General** due to alleged failures in providing information when promised, and **Ernst and Young**'s resignation as auditor of **Catalina Marketing** due to alleged accounting errors. ■



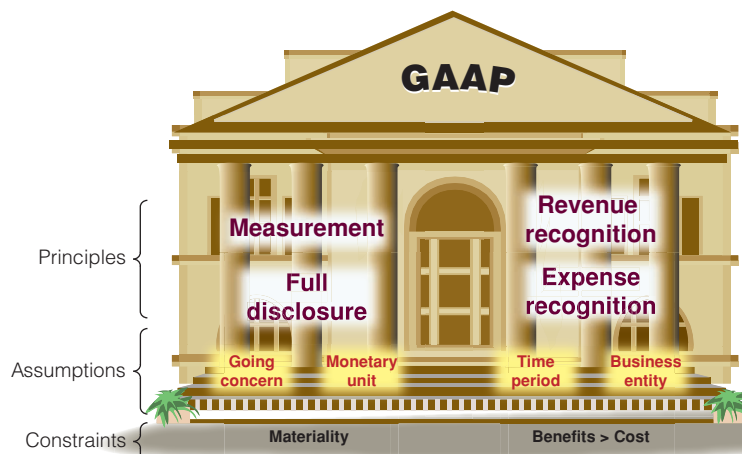
Principles and Assumptions of Accounting Accounting principles (and assumptions) are of two types. *General principles* are the basic assumptions, concepts, and guidelines for preparing financial statements. *Specific principles* are detailed rules used in reporting business transactions and events. General principles stem from long-used accounting practices. Specific principles arise more often from the rulings of authoritative groups.

We need to understand both general and specific principles to effectively use accounting information. Several general principles are described in this section that are relied on in later chapters. General principles (in purple font with white shading) and assumptions (in

red font with yellow shading) are portrayed as building blocks of GAAP in Exhibit 1.7. The specific principles are described as we encounter them in the book.

EXHIBIT 1.7

Building Blocks for GAAP



Accounting Principles General principles consist of at least four basic principles, four assumptions, and two constraints.



The **measurement principle**, also called the **cost principle**, usually means that accounting information is based on actual cost (with a potential for subsequent adjustments to market). Cost is measured on a cash or equal-to-cash basis. This means if cash is given for a service, its cost is measured as the amount of cash paid. If something besides cash is exchanged (such as a car traded for a truck), cost is measured as the cash value of what is given up or received. The cost principle emphasizes reliability and verifiability, and information based on cost is considered objective. *Objectivity* means that information is supported by independent, unbiased evidence; it demands more than a person's opinion. To illustrate, suppose a company pays \$5,000 for equipment. The cost principle requires that this purchase be recorded at a cost of \$5,000. It makes no difference if the owner thinks this equipment is worth \$7,000. Later in the book we introduce *fair value* measures.

Revenue (sales) is the amount received from selling products and services. The **revenue recognition principle** provides guidance on when a company must recognize revenue. To *recognize* means to record it. If revenue is recognized too early, a company would look more profitable than it is. If revenue is recognized too late, a company would look less profitable than it is.

Three concepts are important to revenue recognition. (1) *Revenue is recognized when earned.* The earnings process is normally complete when services are performed or a seller transfers ownership of products to the buyer. (2) *Proceeds from selling products and services need not be in cash.* A common noncash proceed received by a seller is a customer's promise to pay at a future date, called *credit sales*. (3) *Revenue is measured by the cash received plus the cash value of any other items received.*

The **expense recognition principle**, also called the **matching principle**, prescribes that a company record the expenses it incurred to generate the revenue reported. The principles of matching and revenue recognition are key to modern accounting.

The **full disclosure principle** prescribes that a company report the details behind financial statements that would impact users' decisions. Those disclosures are often in footnotes to the statements.

Point: The cost principle is also called the *historical cost principle*.

Example: When a bookstore sells a textbook on credit is its earnings process complete? Answer: A bookstore can record sales for these books minus an amount expected for returns.

Decision Insight



Revenues for the **Green Bay Packers** and **Dallas Cowboys** football teams include ticket sales, television and cable broadcasts, radio rights, concessions, and advertising. Revenues from ticket sales are earned when the NFL team plays each game. Advance ticket sales are not revenues; instead, they represent a liability until the NFL team plays the game for which the ticket was sold. At that point, the liability is removed and revenues are reported. ■



Accounting Assumptions There are four accounting assumptions: the going concern assumption, the monetary unit assumption, the time period assumption, and the business entity assumption.

The **going-concern assumption** means that accounting information reflects a presumption that the business will continue operating instead of being closed or sold. This implies, for example, that property is reported at cost instead of, say, liquidation values that assume closure.

The **monetary unit assumption** means that we can express transactions and events in monetary, or money, units. Money is the common denominator in business. Examples of monetary units are the dollar in the United States, Canada, Australia, and Singapore; and the peso in Mexico, the Philippines, and Chile. The monetary unit a company uses in its accounting reports usually depends on the country where it operates, but many companies today are expressing reports in more than one monetary unit.

The **time period assumption** presumes that the life of a company can be divided into time periods, such as months and years, and that useful reports can be prepared for those periods.

The **business entity assumption** means that a business is accounted for separately from other business entities, including its owner. The reason for this assumption is that separate information about each business is necessary for good decisions. A business entity can take one of three legal forms: *proprietorship*, *partnership*, or *corporation*.

1. A **sole proprietorship**, or simply **proprietorship**, is a business owned by one person in which that person and the company are viewed as one entity for tax and liability purposes.

Point: For currency conversion: xe.com

Point: Abuse of the entity assumption was a main culprit in **Enron's** collapse.



EXHIBIT 1.8

Attributes of Businesses

Attribute Present	Proprietorship	Partnership	Corporation
One owner allowed	yes	no	yes
Business taxed	no	no	yes
Limited liability	no*	no*	yes
Business entity	yes	yes	yes
Legal entity	no	no	yes
Unlimited life	no	no	yes

* Proprietorships and partnerships that are set up as LLCs provide limited liability.

No special legal requirements must be met to start a proprietorship. It is a separate entity for accounting purposes, but it is *not* a separate legal entity from its owner. This means, for example, that a court can order an owner to sell personal belongings to pay a proprietorship's debt. This *unlimited liability* of a proprietorship is a disadvantage. However, an advantage is that a proprietorship's income is not subject to a business income tax but is instead reported and taxed on the owner's personal income tax return. Proprietorship attributes are summarized in Exhibit 1.8, including those for partnerships and corporations.

2. A **partnership** is a business owned by two or more people, called *partners*, which are jointly liable for tax and other obligations. Like a proprietorship, no special legal requirements must be met in starting a partnership. The only requirement is an agreement between partners to run a business together. The agreement can be either oral or written and usually indicates how income and losses are to be shared. A partnership, like a proprietorship, is *not* legally separate from its owners. This means that each partner's share of profits is reported and taxed on that partner's tax return. It also means *unlimited liability* for its partners. However, at least three types of partnerships limit liability. A *limited partnership (LP)* includes a general partner(s) with unlimited liability and a limited partner(s) with liability restricted to the amount invested. A *limited liability partnership (LLP)* restricts partners' liabilities to their own acts and the acts of individuals under their control. This protects an innocent partner from the negligence of another partner, yet all partners remain responsible for partnership debts. A *limited liability company (LLC)* offers the limited liability of a corporation and the tax treatment of a partnership (and proprietorship). **Most proprietorships and partnerships are now organized as LLCs.**
3. A **corporation**, also called *C corporation*, is a business legally separate from its owner or owners, meaning it is responsible for its own acts and its own debts. Separate legal status means that a corporation can conduct business with the rights, duties, and responsibilities of a person. A corporation acts through its managers, who are its legal agents. Separate legal status also means that its owners, who are called **shareholders** (or **stockholders**), are not personally liable for corporate acts and debts. This limited liability is its main advantage. A main disadvantage is what's called *double taxation*—meaning that (1) the corporation income is taxed and (2) any distribution of income to its owners through dividends is taxed as part of the owners' personal income, usually at the 15% rate. (For lower income taxpayers, the dividend tax is less than 15%, and in some cases zero.) An *S corporation*, a corporation with special attributes, does not owe corporate income tax. Owners of S corporations report their share of corporate income with their personal income. Ownership of all corporations is divided into units called **shares** or **stock**. When a corporation issues only one class of stock, we call it **common stock** (or *capital stock*).

Point: Proprietorships and partnerships are usually managed by their owners. In a corporation, the owners (shareholders) elect a board of directors who appoint managers to run the business.

Decision Ethics boxes are role-playing exercises that stress ethics in accounting and business.

Decision Ethics

Answer — p. 29



Entrepreneur You and a friend develop a new design for in-line skates that improves speed by 25% to 30%. You plan to form a business to manufacture and market those skates. You and your friend want to minimize taxes, but your prime concern is potential lawsuits from individuals who might be injured on these skates. What form of organization do you set up? ■



Accounting Constraints There are two basic constraints on financial reporting. The **materiality constraint** prescribes that only information that would influence the decisions of a reasonable person need be disclosed. This constraint looks at both the importance and relative size of an amount. The **cost-benefit constraint** prescribes that only information with benefits of disclosure greater than the costs of providing it need be disclosed.

Sarbanes–Oxley (SOX)

Congress passed the **Sarbanes–Oxley Act**, also called *SOX*, to help curb financial abuses at companies that issue their stock to the public. SOX requires that these public companies apply both accounting oversight and stringent internal controls. The desired results include more transparency, accountability, and truthfulness in reporting transactions.


Compliance with SOX requires documentation and verification of internal controls and increased emphasis on internal control effectiveness. Failure to comply can yield financial penalties, stock market delisting, and criminal prosecution of executives. Management must issue a report stating that internal controls are effective. CEOs and CFOs who knowingly sign off on bogus accounting reports risk millions of dollars in fines and years in prison. **Auditors** also must verify the effectiveness of internal controls.

A listing of some of the more publicized accounting scandals in recent years follows.

Point: An **audit** examines whether financial statements are prepared using GAAP. It does not attest to absolute accuracy of the statements.

Point: *BusinessWeek* reports that external audit costs run about \$35,000 for start-ups, up from \$15,000 pre-SOX.

Company	Alleged Accounting Abuses
Enron	Inflated income, hid debt, and bribed officials
WorldCom	Understated expenses to inflate income and hid debt
Fannie Mae	Inflated income
Adelphia Communications	Understated expenses to inflate income and hid debt
AOL Time Warner	Inflated revenues and income
Xerox	Inflated income
Bristol-Myers Squibb	Inflated revenues and income
Nortel Networks	Understated expenses to inflate income
Global Crossing	Inflated revenues and income
Tyco	Hid debt, and CEO evaded taxes
Halliburton	Inflated revenues and income
Qwest Communications	Inflated revenues and income



To reduce the risk of accounting fraud, companies set up *governance systems*. A company’s governance system includes its owners, managers, employees, board of directors, and other important stakeholders, who work together to reduce the risk of accounting fraud and increase confidence in accounting reports.

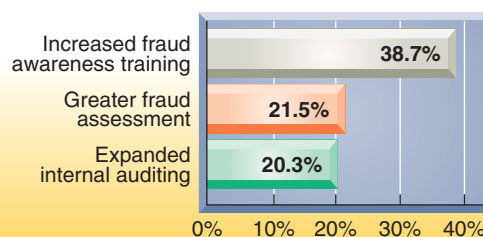
The impact of SOX regulations for accounting and business is discussed throughout this book. Ethics and investor confidence are key to company success. Lack of confidence in accounting numbers impacts company value as evidenced by huge stock price declines for **Enron**, **WorldCom**, **Tyco**, and **ImClone** after accounting misconduct was uncovered.



Fraud

Economic Downturn, Fraud

Upturn? Executives polled show that 80% believe that the economic downturn has or will have a significant impact on fraud control in their companies (Deloitte 2009). The top three responses to the question “What activity would best counter this increased fraud risk?” are tallied in the graphic to the right.





Dodd-Frank

Congress recently passed the **Dodd-Frank Wall Street Reform and Consumer Protection Act**, or *Dodd-Frank*, in a desire to (1) promote U.S. financial stability by improving accountability and transparency in the financial system, (2) put an end to the notion of “too big to fail,” (3) protect the taxpayer by ending bailouts, and (4) protect consumers from abusive financial services practices. It includes provisions whose impacts are unknown until regulators set detailed rules. This section provides a preview of its key financial reporting implications.

Exemption from Section 404(b) of SOX For smaller public entities, there is an exemption for nonaccelerated filers (whose public value is less than \$75 million) from the requirement to obtain an external audit on the effectiveness of internal control over financial reporting per SOX.

Enhancements to Asset-Backed Securitization Dodd-Frank requires that securitizers of financial assets retain an economic interest in a portion of the credit risk of those assets. It requires securitizers to have “skin in the game” when securitizing financial assets. It also requires additional disclosures of the securitization.

Additional Rules on Compensation Dodd-Frank requires independence for all members of the compensation committee. That committee is also responsible for appointment, compensation, and oversight of independent compensation consultants and other advisers. The act requires public companies to allow shareholders a nonbinding vote on the compensation of officers at least once every three years. The SEC must set rules requiring that, in the event of an accounting restatement, an entity set policies mandating recovery (“clawback”) of excess incentive compensation. Also, regulators must set rules that (a) require certain financial institutions to disclose all incentive-based compensation arrangements and (b) prohibit incentive-based arrangements that encourage inappropriate risk taking that could result in material losses. The SEC must require disclosures on whether employees and directors are allowed to hedge the value of the entity’s securities. The Federal Reserve must require certain financial institutions to set up risk committees.

Revisions to SEC Authority and Operations Dodd-Frank alters and expands SEC power. It requires the SEC, when sanctions exceed \$1 million, to pay whistleblowers between 10 percent and 30 percent of the sanction. It requires the SEC to set up a permanent Investor Advisory Committee made up of outside members to consult the SEC on investor interests. The SEC must set up an Office of Investor Advocate to (a) assist investors, (b) consult with the SEC, and (3) annually report to Congress.

Volcker Rule The *Volcker Rule* aims to limit speculative investments by large financial firms and to prohibit most banking entities from engaging in proprietary trading or sponsoring, or investing in, a hedge or private equity fund.

Regulation of OTC Derivatives The act requires entities to trade most derivatives on regulated exchanges to increase transparency. For those derivatives not regulated (“cleared”), there are new reporting and disclosure requirements.

It will take several years for us to assess the costs versus the benefits of the Dodd-Frank Act.

Quick Check

Answers — p. 30



7. What three-step guidelines can help people make ethical decisions?
8. Why are ethics and social responsibility valuable to organizations?
9. Why are ethics crucial in accounting?
10. Who sets U.S. accounting rules?
11. How are U.S. companies affected by international accounting standards?
12. How are the objectivity concept and cost principle related?
13. Why is the business entity assumption important?
14. Why is the revenue recognition principle important?
15. What are the three basic forms of business organization?
16. Identify the owners of corporations and the terminology for ownership units.



TRANSACTION ANALYSIS AND THE ACCOUNTING EQUATION

To understand accounting information, we need to know how an accounting system captures relevant data about transactions, and then classifies, records, and reports data.

Accounting Equation

The accounting system reflects two basic aspects of a company: what it owns and what it owes. *Assets* are resources a company owns or controls. Examples are cash, supplies, equipment, and land, where each carries expected benefits. The claims on a company's assets—what it owes—are separated into owner and nonowner claims. *Liabilities* are what a company owes its nonowners (creditors) in future payments, products, or services. *Equity* (also called owner's equity or capital) refers to the claims of its owner(s). Together, liabilities and equity are the source of funds to acquire assets. The relationship of assets, liabilities, and equity is reflected in the following **accounting equation**:

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

Liabilities are usually shown before equity in this equation because creditors' claims must be paid before the claims of owners. (The terms in this equation can be rearranged; for example, $\text{Assets} - \text{Liabilities} = \text{Equity}$.) The accounting equation applies to all transactions and events, to all companies and forms of organization, and to all points in time. For example, **Research In Motion's** assets equal \$10,204,409, its liabilities equal \$2,601,746, and its equity equals \$7,602,663 (\$ in thousands). Let's now look at the accounting equation in more detail.

Assets *Assets* are resources a company owns or controls. These resources are expected to yield future benefits. Examples are Web servers for an online services company, musical instruments for a rock band, and land for a vegetable grower. The term *receivable* is used to refer to an asset that promises a future inflow of resources. A company that provides a service or product on credit is said to have an account receivable from that customer.

Liabilities *Liabilities* are creditors' claims on assets. These claims reflect company obligations to provide assets, products, or services to others. The term *payable* refers to a liability that promises a future outflow of resources. Examples are wages payable to workers, accounts payable to suppliers, notes payable to banks, and taxes payable to the government.

Equity *Equity* is the owner's claim on assets. Equity is equal to assets minus liabilities. This is the reason equity is also called *net assets* or *residual equity*.

A corporation's equity—often called stockholders' or shareholders' equity—has two parts: contributed capital and retained earnings. **Contributed capital** refers to the amount that stockholders invest in the company—included under the title **common stock**. **Retained earnings** refer to **income** (revenues less expenses) that has *not* been distributed to its stockholders. The distribution of assets to stockholders is called **dividends**, which reduce retained earnings. **Revenues** increase retained earnings (via net income) and are resources generated from a company's earnings activities. Examples are consulting services provided, sales of products, facilities rented to others, and commissions from services. **Expenses** decrease retained earnings and are the cost of assets or services used to earn revenues. Examples are costs of employee time, use of supplies, and advertising, utilities, and insurance services from others. In sum, retained earnings is the accumulated revenues less the accumulated expenses and dividends since the company began. This breakdown of equity yields the following **expanded accounting equation**:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \overbrace{\text{Contributed Capital} + \text{Retained Earnings}}^{\text{Equity}} \\ &= \text{Liabilities} + \text{Common Stock} - \text{Dividends} + \text{Revenues} - \text{Expenses} \end{aligned}$$

Net income occurs when revenues exceed expenses. Net income increases equity. A **net loss** occurs when expenses exceed revenues, which decreases equity.

A1 Define and interpret the accounting equation and each of its components.



Point: The phrases "on credit" and "on account" imply that cash payment will occur at a future date.

Key terms are printed in bold and defined again in the end-of-book glossary.



Decision Insight



Web Info Most organizations maintain Websites that include accounting data—see **Research In Motion (RIM.com)** as an example. The SEC keeps an online database called **EDGAR (www.sec.gov/edgar.shtml)**, which has accounting information for thousands of companies that issue stock to the public (EDGAR is being upgraded and renamed **IDEA**). Information services such as **Finance.Google.com** and **Finance.Yahoo.com** offer additional online data and analysis. ■



P1 Analyze business transactions using the accounting equation.

Transaction Analysis

Business activities can be described in terms of transactions and events. **External transactions** are exchanges of value between two entities, which yield changes in the accounting equation. An example is the sale of ad space by **Twitter**. **Internal transactions** are exchanges within an entity, which may or may not affect the accounting equation. An example is Twitter's use of its supplies, which are reported as expenses when used. **Events** refer to happenings that affect the accounting equation *and* are reliably measured. They include business events such as changes in the market value of certain assets and liabilities and natural events such as floods and fires that destroy assets and create losses. They do not include, for example, the signing of service or product contracts, which by themselves do not impact the accounting equation.

This section uses the accounting equation to analyze 11 selected transactions and events of FastForward, a start-up consulting (service) business, in its first month of operations. Remember that each transaction and event leaves the equation in balance and that assets *always* equal the sum of liabilities and equity.

Transaction 1: Investment by Owner On December 1, Chas Taylor forms a consulting business, named FastForward and set up as a corporation, that focuses on assessing the performance of footwear and accessories. Taylor owns and manages the business. The marketing plan for the business is to focus primarily on publishing online reviews and consulting with clubs, athletes, and others who place orders for footwear and accessories with manufacturers. Taylor personally invests \$30,000 cash in the new company and deposits the cash in a bank account opened under the name of FastForward. After this transaction, the cash (an asset) and the stockholders' equity each equal \$30,000. The source of increase in equity is the owner's investment (stock issuance), which is included in the column titled Common Stock. The effect of this transaction on FastForward is reflected in the accounting equation as follows:

	Assets	=	Liabilities	+	Equity
	Cash	=			Common Stock
(1)	+\$30,000	=			+\$30,000

Transaction 2: Purchase Supplies for Cash FastForward uses \$2,500 of its cash to buy supplies of brand name footwear for performance testing over the next few months. This transaction is an exchange of cash, an asset, for another kind of asset, supplies. It merely changes the form of assets from cash to supplies. The decrease in cash is exactly equal to the increase in supplies. The supplies of footwear are assets because of the expected future benefits from the test results of their performance. This transaction is reflected in the accounting equation as follows:

	Assets		=	Liabilities	+	Equity
	Cash	+				Common Stock
Old Bal.	\$30,000		=			\$30,000
(2)	-2,500	+				
						\$2,500
New Bal.	\$27,500	+				\$30,000
	\$30,000					\$30,000

Point: There are 3 basic types of company operations: (1) **Services**—providing customer services for profit, (2) **Merchandisers**—buying products and re-selling them for profit, and (3) **Manufacturers**—creating products and selling them for profit.



Transaction 3: Purchase Equipment for Cash FastForward spends \$26,000 to acquire equipment for testing footwear. Like transaction 2, transaction 3 is an exchange of one asset, cash, for another asset, equipment. The equipment is an asset because of its expected future benefits from testing footwear. This purchase changes the makeup of assets but does not change the asset total. The accounting equation remains in balance.

	Assets			=	Liabilities	+	Equity
	Cash	+	Supplies	+	Equipment	=	Common Stock
Old Bal.	\$27,500	+	\$2,500	+		=	\$30,000
(3)	-26,000			+	\$26,000		
New Bal.	\$ 1,500	+	\$2,500	+	\$ 26,000	=	\$30,000
	\$30,000				\$30,000		

Transaction 4: Purchase Supplies on Credit Taylor decides more supplies of footwear and accessories are needed. These additional supplies total \$7,100, but as we see from the accounting equation in transaction 3, FastForward has only \$1,500 in cash. Taylor arranges to purchase them on credit from CalTech Supply Company. Thus, FastForward acquires supplies in exchange for a promise to pay for them later. This purchase increases assets by \$7,100 in supplies, and liabilities (called *accounts payable* to CalTech Supply) increase by the same amount. The effects of this purchase follow:

Example: If FastForward pays \$500 cash in transaction 4, how does this partial payment affect the liability to CalTech? What would be FastForward's cash balance? *Answers:* The liability to CalTech would be reduced to \$6,600 and the cash balance would be reduced to \$1,000.

	Assets			=	Liabilities	+	Equity		
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock
Old Bal.	\$1,500	+	\$2,500	+	\$26,000	=		+	\$30,000
(4)		+	7,100			=	+7,100		
New Bal.	\$1,500	+	\$9,600	+	\$26,000	=	\$ 7,100	+	\$30,000
	\$37,100				\$37,100				

Transaction 5: Provide Services for Cash FastForward earns revenues by selling online ad space to manufacturers and by consulting with clients about test results on footwear and accessories. It earns net income only if its revenues are greater than its expenses incurred in earning them. In one of its first jobs, FastForward provides consulting services to a power-walking club and immediately collects \$4,200 cash. The accounting equation reflects this increase in cash of \$4,200 and in equity of \$4,200. This increase in equity is identified in the far right column under Revenues because the cash received is earned by providing consulting services.

	Assets			=	Liabilities	+	Equity				
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Revenues
Old Bal.	\$1,500	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000		
(5)	+4,200									+	\$4,200
New Bal.	\$5,700	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$ 4,200
	\$41,300				\$41,300						

Transactions 6 and 7: Payment of Expenses in Cash FastForward pays \$1,000 rent to the landlord of the building where its facilities are located. Paying this amount allows FastForward to occupy the space for the month of December. The rental payment is reflected in the following accounting equation as transaction 6. FastForward also pays the biweekly \$700 salary of the company's only employee. This is reflected in the accounting equation as transaction 7. Both transactions 6 and 7 are December expenses for FastForward. The costs of both rent and salary are expenses, as opposed to assets, because their benefits are used in December (they



By definition, increases in expenses yield decreases in equity.

have no future benefits after December). These transactions also use up an asset (cash) in carrying out FastForward's operations. The accounting equation shows that both transactions reduce cash and equity. The far right column identifies these decreases as Expenses.

	Assets				=	Liabilities	+	Equity					
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Revenues	-	Expenses
Old Bal.	\$5,700	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$4,200	-	
(6)	-1,000											-	\$1,000
Bal.	4,700	+	9,600	+	26,000	=	7,100	+	30,000	+	4,200	-	1,000
(7)	-700											-	700
New Bal.	\$4,000	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$4,200	-	\$1,700
	\$39,600						\$39,600						

Transaction 8: Provide Services and Facilities for Credit FastForward provides consulting services of \$1,600 and rents its test facilities for \$300 to a podiatric services center. The rental involves allowing members to try recommended footwear and accessories at FastForward's testing area. The center is billed for the \$1,900 total. This transaction results in a new asset, called *accounts receivable*, from this client. It also yields an increase in equity from the two revenue components reflected in the Revenues column of the accounting equation:

	Assets				=	Liabilities	+	Equity							
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Revenues	-	Expenses
Old Bal.	\$4,000	+		+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$4,200	-	\$1,700
(8)		+	\$1,900									+	1,600		
												+	300		
New Bal.	\$4,000	+	\$1,900	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$6,100	-	\$1,700
	\$41,500						\$41,500								

Transaction 9: Receipt of Cash from Accounts Receivable The client in transaction 8 (the podiatric center) pays \$1,900 to FastForward 10 days after it is billed for consulting services. This transaction 9 does not change the total amount of assets and does not affect liabilities or equity. It converts the receivable (an asset) to cash (another asset). It does not create new revenue. Revenue was recognized when FastForward rendered the services in transaction 8, not when the cash is now collected. This emphasis on the earnings process instead of cash flows is a goal of the revenue recognition principle and yields useful information to users. The new balances follow:

Point: Receipt of cash is not always a revenue.

	Assets				=	Liabilities	+	Equity							
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Revenues	-	Expenses
Old Bal.	\$4,000	+	\$1,900	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$6,100	-	\$1,700
(9)	+1,900	-	1,900												
New Bal.	\$5,900	+	\$0	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$6,100	-	\$1,700
	\$41,500						\$41,500								

Transaction 10: Payment of Accounts Payable FastForward pays CalTech Supply \$900 cash as partial payment for its earlier \$7,100 purchase of supplies (transaction 4), leaving \$6,200 unpaid. The accounting equation shows that this transaction decreases FastForward's cash by \$900 and decreases its liability to CalTech Supply by \$900. Equity does not change. This event does not create an expense even though cash flows out of FastForward (instead the expense is recorded when FastForward derives the benefits from these supplies).



	Assets				=	Liabilities	+	Equity							
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Revenues	-	Expenses
Old Bal.	\$5,900	+	\$ 0	+	\$9,600	+	\$26,000	=	\$7,100	+	\$30,000	+	\$6,100	-	\$1,700
(10)	- 900							=	- 900						
New Bal.	\$5,000	+	\$ 0	+	\$9,600	+	\$26,000	=	\$6,200	+	\$30,000	+	\$6,100	-	\$1,700
	\$40,600									\$40,600					

Transaction 11: Payment of Cash Dividend FastForward declares and pays a \$200 cash dividend to its owner. Dividends (decreases in equity) are not reported as expenses because they are not part of the company's earnings process. Since dividends are not company expenses, they are not used in computing net income.

By definition, increases in dividends yield decreases in equity.

	Assets				=	Liabilities	+	Equity									
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	-	Dividends	+	Revenues	-	Expenses
Old Bal.	\$5,000	+	\$ 0	+	\$9,600	+	\$26,000	=	\$6,200	+	\$30,000			+	\$6,100	-	\$1,700
(11)	- 200							=				-	\$200				
New Bal.	\$4,800	+	\$ 0	+	\$9,600	+	\$26,000	=	\$6,200	+	\$30,000	-	\$200	+	\$6,100	-	\$1,700
	\$40,400									\$40,400							

Summary of Transactions

We summarize in Exhibit 1.9 the effects of these 11 transactions of FastForward using the accounting equation. First, we see that the accounting equation remains in balance after each transaction. Second, transactions can be analyzed by their effects on components of the

EXHIBIT 1.9

Summary of Transactions Using the Accounting Equation

	Assets				=	Liabilities	+	Equity											
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	-	Dividends	+	Revenues	-	Expenses		
(1)	\$30,000							=		+	\$30,000								
(2)	- 2,500			+	\$2,500			=											
Bal.	27,500			+	2,500			=			30,000								
(3)	-26,000					+	\$26,000	=											
Bal.	1,500			+	2,500	+	26,000	=			30,000								
(4)				+	\$7,100			=	+\$7,100										
Bal.	1,500			+	9,600	+	26,000	=	7,100	+	30,000								
(5)	+ 4,200							=						+	\$4,200				
Bal.	5,700			+	9,600	+	26,000	=	7,100	+	30,000			+	4,200				
(6)	- 1,000							=									-	\$1,000	
Bal.	4,700			+	9,600	+	26,000	=	7,100	+	30,000			+	4,200		-	1,000	
(7)	- 700							=										-	700
Bal.	4,000			+	9,600	+	26,000	=	7,100	+	30,000			+	4,200		-	1,700	
(8)		+	\$1,900					=						+	\$1,600				
								=						+	300				
Bal.	4,000	+	1,900	+	9,600	+	26,000	=	7,100	+	30,000			+	6,100		-	1,700	
(9)	+ 1,900	-	1,900					=											
Bal.	5,900	+	0	+	9,600	+	26,000	=	7,100	+	30,000			+	6,100		-	1,700	
(10)	- 900							=	- 900										
Bal.	5,000	+	0	+	9,600	+	26,000	=	6,200	+	30,000			+	6,100		-	1,700	
(11)	- 200							=					-	\$200					
Bal.	\$ 4,800	+	\$ 0	+	\$ 9,600	+	\$ 26,000	=	\$ 6,200	+	\$ 30,000	-	\$ 200	+	\$ 6,100	-	\$ 1,700		



Point: Knowing how financial statements are prepared improves our analysis of them. We develop the skills for analysis of financial statements throughout the book. Chapter 13 focuses on financial statement analysis.

accounting equation. For example, in transactions 2, 3, and 9, one asset increased while another asset decreased by equal amounts.

Quick Check

Answers — p. 30



17. When is the accounting equation in balance, and what does that mean?
18. How can a transaction not affect any liability and equity accounts?
19. Describe a transaction increasing equity and one decreasing it.
20. Identify a transaction that decreases both assets and liabilities.

FINANCIAL STATEMENTS

P2 Identify and prepare basic financial statements and explain how they interrelate.

This section introduces us to how financial statements are prepared from the analysis of business transactions. 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 due to earnings activities.
2. **Statement of retained earnings**—explains changes in retained earnings from net income (or loss) and from any 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.

We prepare these financial statements, in this order, using the 11 selected transactions of FastForward. (These statements are technically called *unadjusted*—we explain this in Chapters 2 and 3.)

Income Statement

FastForward's income statement for December is shown at the top of Exhibit 1.10. Information about revenues and expenses is conveniently taken from the Equity columns of Exhibit 1.9. Revenues are reported first on the income statement. They include consulting revenues of \$5,800 from transactions 5 and 8 and rental revenue of \$300 from transaction 8. Expenses are reported after revenues. (For convenience in this chapter, we list larger amounts first, but we can sort expenses in different ways.) Rent and salary expenses are from transactions 6 and 7. Expenses reflect the costs to generate the revenues reported. Net income (or loss) is reported at the bottom of the statement and is the amount earned in December. Stockholders' investments and dividends are *not* part of income.

Point: Net income is sometimes called earnings or profit.

Statement of Retained Earnings

The statement of retained earnings reports information about how retained earnings changes over the reporting period. This statement shows beginning retained earnings, events that increase it (net income), and events that decrease it (dividends and net loss). Ending retained earnings is computed in this statement and is carried over and reported on the balance sheet. FastForward's statement of retained earnings is the second report in Exhibit 1.10. The beginning balance is measured as of the start of business on December 1. It is zero because FastForward did not exist before then. An existing business reports the beginning balance equal to that as of the end of the prior reporting period (such as from November 30). FastForward's statement shows the \$4,400 of net income earned during the period. This links the income statement to the statement of retained earnings (see line ①). The statement also reports the \$200 cash dividend and FastForward's end-of-period retained earnings balance.

Point: The statement of retained earnings is also called the *statement of changes in retained earnings*. Note: Beg. Retained Earnings + Net Income – Dividends = End. Retained Earnings

**EXHIBIT 1.10**

Financial Statements and Their Links

FASTFORWARD Income Statement For Month Ended December 31, 2011		
Revenues		
Consulting revenue (\$4,200 + \$1,600)	\$ 5,800	
Rental revenue	<u>300</u>	
Total revenues		\$ 6,100
Expenses		
Rent expense	1,000	
Salaries expense	<u>700</u>	
Total expenses		<u>1,700</u>
Net income		<u><u>\$ 4,400</u></u>

Point: A statement's heading identifies the company, the statement title, and the date or time period.

FASTFORWARD Statement of Retained Earnings For Month Ended December 31, 2011		
Retained earnings, December 1, 2011	\$ 0	①
Plus: Net income	<u>4,400</u>	
	4,400	
Less: Dividends	<u>200</u>	
Retained earnings, December 31, 2011	<u><u>\$ 4,200</u></u>	

Point: Arrow lines show how the statements are linked. ① Net income is used to compute equity. ② Retained earnings is used to prepare the balance sheet. ③ Cash from the balance sheet is used to reconcile the statement of cash flows.

FASTFORWARD Balance Sheet December 31, 2011			
Assets		Liabilities	
Cash	<u>\$ 4,800</u>	Accounts payable	\$ 6,200
Supplies	9,600	Total liabilities	<u>6,200</u>
Equipment	26,000	Equity	
		Common stock	30,000
		Retained earnings	<u>4,200</u>
		Total equity	<u>34,200</u>
Total assets	<u><u>\$ 40,400</u></u>	Total liabilities and equity	<u><u>\$ 40,400</u></u>

Point: The income statement, the statement of retained earnings, and the statement of cash flows are prepared for a *period* of time. The balance sheet is prepared as of a *point* in time.

FASTFORWARD Statement of Cash Flows For Month Ended December 31, 2011		
Cash flows from operating activities		
Cash received from clients (\$4,200 + \$1,900)	\$ 6,100	
Cash paid for supplies (\$2,500 + \$900)	(3,400)	
Cash paid for rent	(1,000)	
Cash paid to employee	<u>(700)</u>	
Net cash provided by operating activities		\$ 1,000
Cash flows from investing activities		
Purchase of equipment	<u>(26,000)</u>	
Net cash used by investing activities		(26,000)
Cash flows from financing activities		
Investments by stockholder	30,000	
Dividends to stockholder	<u>(200)</u>	
Net cash provided by financing activities		<u>29,800</u>
Net increase in cash		\$ 4,800
Cash balance, December 1, 2011		<u>0</u>
Cash balance, December 31, 2011		<u><u>\$ 4,800</u></u>

Point: A single ruled line denotes an addition or subtraction. Final totals are double underlined. Negative amounts are often in parentheses.



Balance Sheet

FastForward's balance sheet is the third report in Exhibit 1.10. This statement refers to FastForward's financial condition at the close of business on December 31. The left side of the balance sheet lists FastForward's assets: cash, supplies, and equipment. The upper right side of the balance sheet shows that FastForward owes \$6,200 to creditors. Any other liabilities (such as a bank loan) would be listed here. The equity balance is \$34,200. Line ② shows the link between the ending balance of the statement of retained earnings and the retained earnings balance on the balance sheet. (This presentation of the balance sheet is called the *account form*: assets on the left and liabilities and equity on the right. Another presentation is the *report form*: assets on top, followed by liabilities and then equity at the bottom. Either presentation is acceptable.) As always, we see the accounting equation applies: Assets of \$40,400 = Liabilities of \$6,200 + Equity of \$34,200.

Decision Maker boxes are role-playing exercises that stress the relevance of accounting.

Decision Maker

Answer — p. 29



Retailer You open a wholesale business selling entertainment equipment to retail outlets. You find that most of your customers demand to buy on credit. How can you use the balance sheets of these customers to help you decide which ones to extend credit to? ■

Statement of Cash Flows

FastForward's statement of cash flows is the final report in Exhibit 1.10. The first section reports cash flows from *operating activities*. It shows the \$6,100 cash received from clients and the \$5,100 cash paid for supplies, rent, and employee salaries. Outflows are in parentheses to denote subtraction. Net cash provided by operating activities for December is \$1,000. If cash paid exceeded the \$5,100 cash received, we would call it "cash used by operating activities." The second section reports *investing activities*, which involve buying and selling assets such as land and equipment that are held for *long-term use* (typically more than one year). The only investing activity is the \$26,000 purchase of equipment. The third section shows cash flows from *financing activities*, which include the *long-term* borrowing and repaying of cash from lenders and the cash investments from, and dividends to, stockholders. FastForward reports \$30,000 from the owner's initial investment and the \$200 cash dividend. The net cash effect of all financing transactions is a \$29,800 cash inflow. The final part of the statement shows FastForward increased its cash balance by \$4,800 in December. Since it started with no cash, the ending balance is also \$4,800—see line ③. We see that cash flow numbers are different from income statement (*accrual*) numbers, which is common.

Point: Statement of cash flows has three main sections: operating, investing, and financing.

Point: Payment for supplies is an operating activity because supplies are expected to be used up in short-term operations (typically less than one year).

Point: Investing activities refer to long-term asset investments by the company, not to owner investments.

Quick Check

Answers — p. 30



21. Explain the link between the income statement and the statement of retained earnings.
22. Describe the link between the balance sheet and the statement of retained earnings.
23. Discuss the three major sections of the statement of cash flows.



GLOBAL VIEW

Accounting according to U.S. GAAP is similar, but not identical, to IFRS. Throughout the book we use this last section to identify major similarities and differences between IFRS and U.S. GAAP for the materials in each chapter.

Basic Principles Both U.S. GAAP and IFRS include broad and similar guidance for accounting. However, neither system specifies particular account names nor the detail required. (A typical *chart of accounts* is shown near the end of this book.) IFRS does require certain minimum line items be reported in the balance sheet along with other minimum disclosures that U.S. GAAP does not. On the other hand, U.S. GAAP requires disclosures for the current and prior two years for the income statement, statement of cash flows, and statement of retained earnings (equity), while IFRS requires disclosures for the current and prior year. Still, the basic principles behind these two systems are similar.



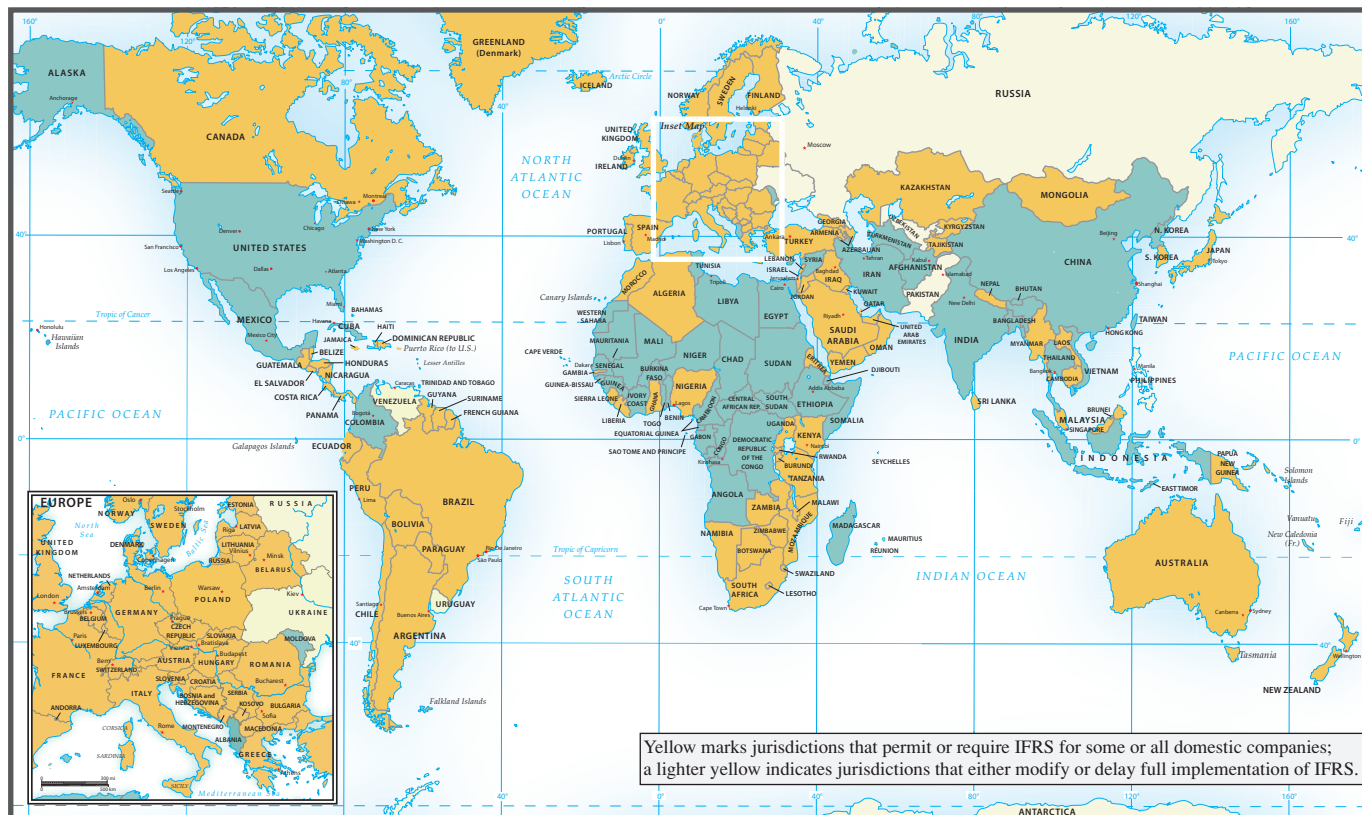
Transaction Analysis Both U.S. GAAP and IFRS apply transaction analysis identically as shown in this chapter. Although some variations exist in revenue and expense recognition and other principles, all of the transactions in this chapter are accounted for identically under these two systems. It is often said that U.S. GAAP is more *rules-based* whereas IFRS is more *principles-based*. The main difference on the rules versus principles focus is with the approach in deciding how to account for certain transactions. Under U.S. GAAP, the approach is more focused on strictly following the accounting rules; under IFRS, the approach is more focused on a review of the situation and how accounting can best reflect it. This difference typically impacts advanced topics beyond the introductory course.

Financial Statements Both U.S. GAAP and IFRS prepare the same four basic financial statements. To illustrate, a condensed version of **Nokia's** income statement follows (numbers are in euros millions). Nokia is a leader in mobile technology, from smartphones to mobile computers. Similar condensed versions can be prepared for the other three statements.

NOKIA

NOKIA	
Income Statement (in € millions)	
For Year Ended December 31, 2009	
Net sales	40,984
Cost of sales	27,720
Research, selling, administrative, and other expenses	12,302
Taxes	<u>702</u>
Net income (profit)	<u>260</u>

Status of IFRS Accounting impacts companies across the world, which requires us to take a global view. IFRS is now adopted or accepted in over 115 countries, including over 30 member-states of the EU. The map below gives us some sense of its prevalence. The FASB and IASB continue to work on the convergence of IFRS and U.S. GAAP. Further, the SEC has a “roadmap” for ultimate use of IFRS by U.S. companies. Currently, the roadmap extends out over the next three to five years.





Decision Analysis (a section at the end of each chapter) introduces and explains ratios helpful in decision making using real company data. Instructors can skip this section and cover all ratios in Chapter 13.



Decision Analysis

Return on Assets

A2 Compute and interpret return on assets.

A *Decision Analysis* section at the end of each chapter is devoted to financial statement analysis. We organize financial statement analysis into four areas: (1) liquidity and efficiency, (2) solvency, (3) profitability, and (4) market prospects—Chapter 13 has a ratio listing with definitions and groupings by area. When analyzing ratios, we need benchmarks to identify good, bad, or average levels. Common benchmarks include the company’s prior levels and those of its competitors.

This chapter presents a profitability measure: return on assets. Return on assets is useful in evaluating management, analyzing and forecasting profits, and planning activities. **Dell** has its marketing department compute return on assets for *every* order. **Return on assets (ROA)**, also called *return on investment (ROI)*, is defined in Exhibit 1.11.

EXHIBIT 1.11

Return on Assets

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Average total assets}}$$

Net income is from the annual income statement, and average total assets is computed by adding the beginning and ending amounts for that same period and dividing by 2. To illustrate, **Best Buy** reports net income of \$1,317 million for fiscal year 2010. At the beginning of fiscal 2010, its total assets are \$15,826 million and at the end of fiscal 2010, they total \$18,302 million. Best Buy’s return on assets for fiscal 2010 is:

$$\text{Return on assets} = \frac{\$1,317 \text{ million}}{(\$15,826 \text{ million} + \$18,302 \text{ million})/2} = 7.7\%$$

Is a 7.7% return on assets good or bad for Best Buy? To help answer this question, we compare (benchmark) Best Buy’s return with its prior performance, the returns of competitors (such as **RadioShack**, **Conn’s**, and **Rex Stores**), and the returns from alternative investments. Best Buy’s return for each of the prior five years is in the second column of Exhibit 1.12, which ranges from 7.0% to 10.8%.

EXHIBIT 1.12

Best Buy and Industry Returns



Fiscal Year	Return on Assets	
	Best Buy	Industry
2010	7.7%	2.9%
2009	7.0	2.5
2008	10.7	3.4
2007	10.8	3.5
2006	10.3	3.3

Best Buy shows a fairly stable pattern of good returns that reflect its productive use of assets. There is a decline in its 2009 return reflecting the recessionary period. We compare Best Buy’s return to the normal return for similar merchandisers of electronic products (third column). Industry averages are available from services such as **Dun & Bradstreet’s** *Industry Norms and Key Ratios* and **The Risk Management Association’s** *Annual Statement Studies*. When compared to the industry, Best Buy performs well.



Decision Maker

Answer — p. 29



Business Owner You own a small winter ski resort that earns a 21% return on its assets. An opportunity to purchase a winter ski equipment manufacturer is offered to you. This manufacturer earns a 19% return on its assets. The industry return for this manufacturer is 14%. Do you purchase this manufacturer? ■

Each **Decision Analysis** section ends with a role-playing scenario to show the usefulness of ratios.

The **Demonstration Problem** is a review of key chapter content. The **Planning the Solution** offers strategies in solving the problem.

DEMONSTRATION PROBLEM

After several months of planning, Jasmine Worthy started a haircutting business called Expressions. The following events occurred during its first month of business.

- a. On August 1, Worthy invested \$3,000 cash and \$15,000 of equipment in Expressions in exchange for its common stock.
- b. On August 2, Expressions paid \$600 cash for furniture for the shop.
- c. On August 3, Expressions paid \$500 cash to rent space in a strip mall for August.
- d. On August 4, it purchased \$1,200 of equipment on credit for the shop (using a long-term note payable).
- e. On August 5, Expressions opened for business. Cash received from haircutting services in the first week and a half of business (ended August 15) was \$825.
- f. On August 15, it provided \$100 of haircutting services on account.
- g. On August 17, it received a \$100 check for services previously rendered on account.
- h. On August 17, it paid \$125 cash to an assistant for hours worked during the grand opening.
- i. Cash received from services provided during the second half of August was \$930.
- j. On August 31, it paid a \$400 installment toward principal on the note payable entered into on August 4.
- k. On August 31, it paid \$900 in cash dividends to Worthy.

Required

1. Arrange the following asset, liability, and equity titles in a table similar to the one in Exhibit 1.9: Cash; Accounts Receivable; Furniture; Store Equipment; Note Payable; Common Stock; Dividends; Revenues; and Expenses. Show the effects of each transaction using the accounting equation.
2. Prepare an income statement for August.
3. Prepare a statement of retained earnings for August.
4. Prepare a balance sheet as of August 31.
5. Prepare a statement of cash flows for August.
6. Determine the return on assets ratio for August.

PLANNING THE SOLUTION

- Set up a table like Exhibit 1.9 with the appropriate columns for accounts.
- Analyze each transaction and show its effects as increases or decreases in the appropriate columns. Be sure the accounting equation remains in balance after each transaction.
- Prepare the income statement, and identify revenues and expenses. List those items on the statement, compute the difference, and label the result as *net income* or *net loss*.
- Use information in the Equity columns to prepare the statement of retained earnings.
- Use information in the last row of the transactions table to prepare the balance sheet.
- Prepare the statement of cash flows; include all events listed in the Cash column of the transactions table. Classify each cash flow as operating, investing, or financing.
- Calculate return on assets by dividing net income by average assets.



SOLUTION TO DEMONSTRATION PROBLEM

1.

Assets				=	Liabilities	+	Equity									
Cash	+	Accounts Receivable	+	Furniture	+	Store Equipment	=	Note Payable	+	Common Stock	-	Dividends	+	Revenues	-	Expenses
a. \$3,000						\$15,000				\$18,000						
b. - 600			+ \$600													
Bal. 2,400	+		600	+	15,000	=				18,000						
c. - 500																- \$500
Bal. 1,900	+		600	+	15,000	=				18,000						500
d.						+ 1,200		+ \$1,200								
Bal. 1,900	+		600	+	16,200	=	1,200			18,000						500
e. + 825														+ \$ 825		
Bal. 2,725	+		600	+	16,200	=	1,200			18,000				825		500
f.		+ \$100												+ 100		
Bal. 2,725	+	100	600	+	16,200	=	1,200			18,000				925		500
g. + 100		- 100														
Bal. 2,825	+	0	600	+	16,200	=	1,200			18,000				925		500
h. - 125																- 125
Bal. 2,700	+	0	600	+	16,200	=	1,200			18,000				925		625
i. + 930														+ 930		
Bal. 3,630	+	0	600	+	16,200	=	1,200			18,000				1,855		625
j. - 400								- 400								
Bal. 3,230	+	0	600	+	16,200	=	800			18,000				1,855		625
k. - 900													- \$900			
Bal. <u>\$ 2,330</u>	+	<u>0</u>	<u>\$600</u>	+	<u>\$ 16,200</u>	=	<u>\$ 800</u>			<u>\$ 18,000</u>			<u>- \$900</u>	<u>+ \$1,855</u>		<u>- \$625</u>

2.

EXPRESSIONS	
Income Statement	
For Month Ended August 31	
Revenues	
Haircutting services revenue	\$1,855
Expenses	
Rent expense	\$500
Wages expense	125
Total expenses	625
Net Income	<u>\$1,230</u>

3.

EXPRESSIONS	
Statement of Retained Earnings	
For Month Ended August 31	
Retained earnings, August 1*	\$ 0
Plus: Net income	1,230
	1,230
Less: Dividend to owner	900
Retained earnings, August 31	<u>\$ 330</u>

* If Expressions had been an existing business from a prior period, the beginning retained earnings balance would equal the retained earnings balance from the end of the prior period.



4.

EXPRESSIONS Balance Sheet August 31			
Assets		Liabilities	
Cash	\$ 2,330	Note payable	\$ 800
Furniture	600	Equity	
Store equipment	16,200	Common stock	18,000
		Retained earnings.....	<u>330</u>
		Total equity	<u>18,330</u>
Total assets	<u>\$19,130</u>	Total liabilities and equity.....	<u>\$19,130</u>

5.

EXPRESSIONS Statement of Cash Flows For Month Ended August 31	
Cash flows from operating activities	
Cash received from customers	\$1,855
Cash paid for rent	(500)
Cash paid for wages	<u>(125)</u>
Net cash provided by operating activities	\$1,230
Cash flows from investing activities	
Cash paid for furniture	(600)
Cash flows from financing activities	
Investments from stockholders	3,000
Cash dividends to stockholders	(900)
Partial repayment of (long-term) note payable	<u>(400)</u>
Net cash provided by financing activities	<u>1,700</u>
Net increase in cash	\$2,330
Cash balance, August 1	<u>0</u>
Cash balance, August 31	<u>\$2,330</u>

$$6. \text{ Return on assets} = \frac{\text{Net income}}{\text{Average assets}} = \frac{\$1,230}{(\$18,000^* + \$19,130)/2} = \frac{\$1,230}{\$18,565} = \underline{\underline{6.63\%}}$$

* Uses the initial \$18,000 investment as the beginning balance for the *start-up period only*.

APPENDIX

Return and Risk Analysis

1A

This appendix explains return and risk analysis and its role in business and accounting.

Net income is often linked to **return**. Return on assets (ROA) is stated in ratio form as income divided by assets invested. For example, banks report return from a savings account in the form of an interest return such as 4%. If we invest in a savings account or in U.S. Treasury bills, we expect a return of around 2% to 7%. We could also invest in a company's stock, or even start our own business. How do we decide among these investment options? The answer depends on our trade-off between return and risk.

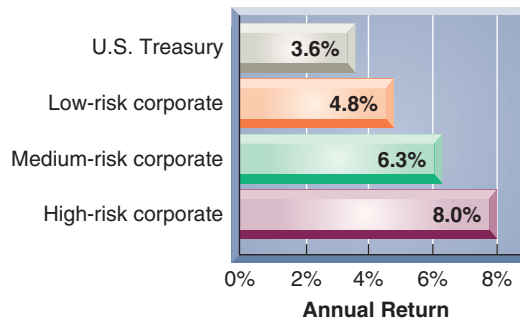
A3 Explain the relation between return and risk.



Risk is the uncertainty about the return we will earn. All business investments involve risk, but some investments involve more risk than others. The lower the risk of an investment, the lower is our expected return. The reason that savings accounts pay such a low return is the low risk of not being repaid with interest (the government guarantees most savings accounts from default). If we buy a share of eBay or any other company, we might obtain a large return. However, we have no guarantee of any return; there is even the risk of loss.

EXHIBIT 1A.1

Average Returns for Bonds with Different Risks



The bar graph in Exhibit 1A.1 shows recent returns for 10-year bonds with different risks. *Bonds* are written promises by organizations to repay amounts loaned with interest. U.S. Treasury bonds provide a low expected return, but they also offer low risk since they are backed by the U.S. government. High-risk corporate bonds offer a much larger potential return but with much higher risk.

The trade-off between return and risk is a normal part of business. Higher risk implies higher, but riskier, expected returns. To help us make better decisions, we use accounting information to assess both return and risk.

APPENDIX

1B

Business Activities and the Accounting Equation

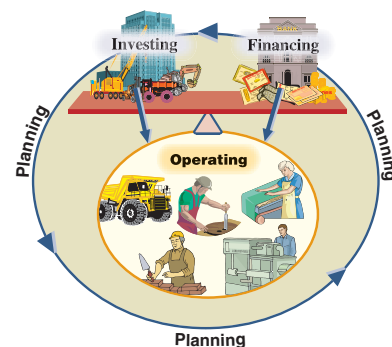
C5 Identify and describe the three major activities of organizations.

This appendix explains how the accounting equation is derived from business activities.

There are three major types of business activities: financing, investing, and operating. Each of these requires planning. *Planning* involves defining an organization's ideas, goals, and actions. Most public corporations use the *Management Discussion and Analysis* section in their annual reports to communicate plans. However, planning is not cast in stone. This adds *risk* to both setting plans and analyzing them.

Financing *Financing activities* provide the means organizations use to pay for resources such as land, buildings, and equipment to carry out plans. Organizations are careful in acquiring and managing financing activities because they can determine success or failure. The two sources of financing are owner and nonowner. *Owner financing* refers to resources contributed by the owner along with any income the owner leaves in the organization. *Nonowner* (or *creditor*) *financing* refers to resources contributed by creditors (lenders). *Financial management* is the task of planning how to obtain these resources and to set the right mix between owner and creditor financing.

Investing *Investing activities* are the acquiring and disposing of resources (assets) that an organization uses to acquire and sell its products or services. Assets are funded by an organization's financing. Organizations differ on the amount and makeup of assets. Some require land and factories to operate. Others need only an office. Determining the amount and type of assets for operations is called *asset management*. Invested amounts are referred to as *assets*. Financing is made up of creditor and owner financing, which hold claims on assets. Creditors' claims are called *liabilities*, and the owner's claim is called *equity*. This basic equality is called the *accounting equation* and can be written as: $\text{Assets} = \text{Liabilities} + \text{Equity}$.



Point: Management must understand accounting data to set financial goals, make financing and investing decisions, and evaluate operating performance.

Point: Investing (assets) and financing (liabilities plus equity) totals are *always* equal.

EXHIBIT 1B.1

Activities of Organizations

Operating *Operating activities* involve using resources to research, develop, purchase, produce, distribute, and market products and services. Sales and revenues are the inflow of assets from selling products and services. Costs and expenses are the outflow of assets to support operating activities. *Strategic management* is the process of determining the right mix of operating activities for the type of organization, its plans, and its market.

Exhibit 1B.1 summarizes business activities. Planning is part of each activity and gives them meaning and focus. Investing



(assets) and financing (liabilities and equity) are set opposite each other to stress their balance. Operating activities are below investing and financing activities to show that operating activities are the result of investing and financing.

Summary

A Summary organized by learning objectives concludes each chapter.

- C1 Explain the purpose and importance of accounting.** Accounting is an information and measurement system that aims to identify, record, and communicate relevant, reliable, and comparable information about business activities. It helps assess opportunities, products, investments, and social and community responsibilities.
- C2 Identify users and uses of, and opportunities in, accounting.** Users of accounting are both internal and external. Some users and uses of accounting include (a) managers in controlling, monitoring, and planning; (b) lenders for measuring the risk and return of loans; (c) shareholders for assessing the return and risk of stock; (d) directors for overseeing management; and (e) employees for judging employment opportunities. Opportunities in accounting include financial, managerial, and tax accounting. They also include accounting-related fields such as lending, consulting, managing, and planning.
- C3 Explain why ethics are crucial to accounting.** The goal of accounting is to provide useful information for decision making. For information to be useful, it must be trusted. This demands ethical behavior in accounting.
- C4 Explain generally accepted accounting principles and define and apply several accounting principles.** Generally accepted accounting principles are a common set of standards applied by accountants. Accounting principles aid in producing relevant, reliable, and comparable information. Four principles underlying financial statements were introduced: cost, revenue recognition, matching, and full disclosure. Financial statements also reflect four assumptions: going-concern, monetary unit, time period, and business entity.
- C5^B Identify and describe the three major activities of organizations.** Organizations carry out three major activities: financing, investing, and operating. Financing is the means used to

pay for resources such as land, buildings, and machines. Investing refers to the buying and selling of resources used in acquiring and selling products and services. Operating activities are those necessary for carrying out the organization's plans.

A1 Define and interpret the accounting equation and each of its components. The accounting equation is: $\text{Assets} = \text{Liabilities} + \text{Equity}$. Assets are resources owned by a company. Liabilities are creditors' claims on assets. Equity is the owner's claim on assets (*the residual*). The expanded accounting equation is: $\text{Assets} = \text{Liabilities} + [\text{Common Stock} - \text{Dividends} + \text{Revenues} - \text{Expenses}]$.

A2 Compute and interpret return on assets. Return on assets is computed as net income divided by average assets. For example, if we have an average balance of \$100 in a savings account and it earns \$5 interest for the year, the return on assets is $\$5/\100 , or 5%.

A3^A Explain the relation between return and risk. *Return* refers to income, and *risk* is the uncertainty about the return we hope to make. All investments involve risk. The lower the risk of an investment, the lower is its expected return. Higher risk implies higher, but riskier, expected return.

P1 Analyze business transactions using the accounting equation. A *transaction* is an exchange of economic consideration between two parties. Examples include exchanges of products, services, money, and rights to collect money. Transactions always have at least two effects on one or more components of the accounting equation. This equation is always in balance.

P2 Identify and prepare basic financial statements and explain how they interrelate. Four financial statements report on an organization's activities: balance sheet, income statement, statement of retained earnings, and statement of cash flows.

Guidance Answers to Decision Maker and Decision Ethics



Entrepreneur You should probably form the business as a corporation if potential lawsuits are of prime concern. The corporate form of organization protects your personal property from lawsuits directed at the business and places only the corporation's resources at risk. A downside of the corporate form is double taxation: The corporation must pay taxes on its income, and you normally must pay taxes on any money distributed to you from the business (even though the corporation already paid taxes on this money). You should also

examine the ethical and socially responsible aspects of starting a business in which you anticipate injuries to others. Formation as an LLC or S corp. should also be explored.

Retailer You can use the accounting equation ($\text{Assets} = \text{Liabilities} + \text{Equity}$) to help identify risky customers to whom you would likely not want to extend credit. A balance sheet provides amounts for each of these key components. The lower a customer's equity is



relative to liabilities, the less likely you would be to extend credit. A low equity means the business has little value that does not already have creditor claims to it.

Business Owner The 19% return on assets for the manufacturer exceeds the 14% industry return (and many others). This is a positive

factor for a potential purchase. Also, the purchase of this manufacturer is an opportunity to spread your risk over two businesses as opposed to one. Still, you should hesitate to purchase a business whose return of 19% is lower than your current resort's return of 21%. You are probably better off directing efforts to increase investment in your resort, assuming you can continue to earn a 21% return.

Guidance Answers to Quick Checks



1. Accounting is an information and measurement system that identifies, records, and communicates relevant information to help people make better decisions.
2. Recordkeeping, also called *bookkeeping*, is the recording of financial transactions and events, either manually or electronically. Recordkeeping is essential to data reliability; but accounting is this and much more. Accounting includes identifying, measuring, recording, reporting, and analyzing business events and transactions.
3. Technology offers increased accuracy, speed, efficiency, and convenience in accounting.
4. External users of accounting include lenders, shareholders, directors, customers, suppliers, regulators, lawyers, brokers, and the press. Internal users of accounting include managers, officers, and other internal decision makers involved with strategic and operating decisions.
5. Internal users (managers) include those from research and development, purchasing, human resources, production, distribution, marketing, and servicing.
6. Internal controls are procedures set up to protect assets, ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies. Internal controls are crucial for relevant and reliable information.
7. Ethical guidelines are threefold: (1) identify ethical concerns using personal ethics, (2) analyze options considering all good and bad consequences, and (3) make ethical decisions after weighing all consequences.
8. Ethics and social responsibility yield good behavior, and they often result in higher income and a better working environment.
9. For accounting to provide useful information for decisions, it must be trusted. Trust requires ethics in accounting.
10. Two major participants in setting rules include the SEC and the FASB. (*Note:* Accounting rules reflect society's needs, not those of accountants or any other single constituency.)
11. Most U.S. companies are not directly affected by international accounting standards. International standards are put forth as preferred accounting practices. However, stock exchanges and other parties are increasing the pressure to narrow differences in worldwide accounting practices. International accounting standards are playing an important role in that process.
12. The objectivity concept and cost principle are related in that most users consider information based on cost as objective. Information prepared using both is considered highly reliable and often relevant.
13. Users desire information about the performance of a specific entity. If information is mixed between two or more entities, its usefulness decreases.
14. The revenue recognition principle gives preparers guidelines on when to recognize (record) revenue. This is important; for example, if revenue is recognized too early, the statements report revenue sooner than it should and the business looks more profitable than it is. The reverse is also true.
15. The three basic forms of business organization are sole proprietorships, partnerships, and corporations.
16. Owners of corporations are called *shareholders* (or *stockholders*). Corporate ownership is divided into units called *shares* (or *stock*). The most basic of corporate shares is common stock (or capital stock).
17. The accounting equation is: $\text{Assets} = \text{Liabilities} + \text{Equity}$. This equation is always in balance, both before and after each transaction.
18. A transaction that changes the makeup of assets would not affect liability and equity accounts. FastForward's transactions 2 and 3 are examples. Each exchanges one asset for another.
19. Earning revenue by performing services, as in FastForward's transaction 5, increases equity (and assets). Incurring expenses while servicing clients, such as in transactions 6 and 7, decreases equity (and assets). Other examples include owner investments (stock issuances) that increase equity and dividends that decrease equity.
20. Paying a liability with an asset reduces both asset and liability totals. One example is FastForward's transaction 10 that reduces a payable by paying cash.
21. An income statement reports a company's revenues and expenses along with the resulting net income or loss. A statement of retained earnings shows changes in retained earnings, including that from net income or loss. Both statements report transactions occurring over a period of time.
22. The balance sheet describes a company's financial position (assets, liabilities, and equity) at a point in time. The retained earnings amount in the balance sheet is obtained from the statement of retained earnings.
23. Cash flows from operating activities report cash receipts and payments from the primary business the company engages in. Cash flows from investing activities involve cash transactions from buying and selling long-term assets. Cash flows from financing activities include long-term cash borrowings and repayments to lenders and the cash investments from, and dividends to, the stockholders.



← A list of key terms with page references concludes each chapter (a complete glossary is at the end of the book).

Key Terms

Accounting (p. 4)	External users (p. 5)	Net loss (p. 15)
Accounting equation (p. 15)	Financial accounting (p. 5)	Partnership (p. 12)
Assets (p. 15)	Financial Accounting Standards Board (FASB) (p. 9)	Proprietorship (p. 11)
Audit (p. 13)	Full disclosure principle (p. 11)	Recordkeeping (p. 4)
Auditors (p. 13)	Generally accepted accounting principles (GAAP) (p. 9)	Retained earnings (p. 15)
Balance sheet (p. 20)	Going-concern assumption (p. 11)	Return (p. 28)
Bookkeeping (p. 4)	Income (p. 15)	Return on assets (p. 24)
Business entity assumption (p. 11)	Income statement (p. 20)	Revenue recognition principle (p. 11)
Common stock (p. 12)	Internal transactions (p. 16)	Revenues (p. 15)
Conceptual framework (p. 10)	Internal users (p. 6)	Risk (p. 28)
Contributed capital (p. 15)	International Accounting Standards Board (IASB) (p. 9)	Sarbanes–Oxley Act (p. 13)
Corporation (p. 12)	International Financial Reporting Standards (IFRS) (p. 9)	Securities and Exchange Commission (SEC) (p. 9)
Cost-benefit constraint (p. 13)	Liabilities (p. 15)	Shareholders (p. 12)
Cost principle (p. 11)	Managerial accounting (p. 6)	Shares (p. 12)
Dividends (p. 15)	Matching principle (p. 11)	Sole proprietorship (p. 11)
Equity (p. 15)	Materiality constraint (p. 13)	Statement of cash flows (p. 20)
Ethics (p. 8)	Measurement principle (p. 11)	Statement of retained earnings (p. 20)
Events (p. 16)	Monetary unit assumption (p. 11)	Stock (p. 12)
Expanded accounting equation (p. 15)	Net income (p. 15)	Stockholders (p. 12)
Expense recognition principle (p. 11)		Time period assumption (p. 11)
Expenses (p. 15)		
External transactions (p. 16)		

Multiple Choice Quiz

Answers on p. 49

mhhe.com/wildFA6e


Additional quiz questions are available at the book's Website.

- A building is offered for sale at \$500,000 but is currently assessed at \$400,000. The purchaser of the building believes the building is worth \$475,000, but ultimately purchases the building for \$450,000. The purchaser records the building at:
 - \$50,000
 - \$400,000
 - \$450,000
 - \$475,000
 - \$500,000
- On December 30, 2010, **KPMG** signs a \$150,000 contract to provide accounting services to one of its clients in 2011. KPMG has a December 31 year-end. Which accounting principle or assumption requires KPMG to record the accounting services revenue from this client in 2011 and not 2010?
 - Business entity assumption
 - Revenue recognition principle
 - Monetary unit assumption
 - Cost principle
 - Going-concern assumption
- If the assets of a company increase by \$100,000 during the year and its liabilities increase by \$35,000 during the same year, then the change in equity of the company during the year must have been:
 - An increase of \$135,000.
 - A decrease of \$135,000.
 - A decrease of \$65,000.
 - An increase of \$65,000.
 - An increase of \$100,000.
- Brunswick** borrows \$50,000 cash from Third National Bank. How does this transaction affect the accounting equation for Brunswick?
 - Assets increase by \$50,000; liabilities increase by \$50,000; no effect on equity.
 - Assets increase by \$50,000; no effect on liabilities; equity increases by \$50,000.
 - Assets increase by \$50,000; liabilities decrease by \$50,000; no effect on equity.
 - No effect on assets; liabilities increase by \$50,000; equity increases by \$50,000.
 - No effect on assets; liabilities increase by \$50,000; equity decreases by \$50,000.












5. **Geek Squad** performs services for a customer and bills the customer for \$500. How would Geek Squad record this transaction?
- Accounts receivable increase by \$500; revenues increase by \$500.
 - Cash increases by \$500; revenues increase by \$500.
 - Accounts receivable increase by \$500; revenues decrease by \$500.
 - Accounts receivable increase by \$500; accounts payable increase by \$500.
 - Accounts payable increase by \$500; revenues increase by \$500.

^{A(B)} *Superscript letter A (B) denotes assignments based on Appendix IA (IB).*

 *Icon denotes assignments that involve decision making.*

Discussion Questions

- What is the purpose of accounting in society?
- Technology is increasingly used to process accounting data. Why then must we study and understand accounting?
-  Identify four kinds of external users and describe how they use accounting information.
-  What are at least three questions business owners and managers might be able to answer by looking at accounting information?
- Identify three actual businesses that offer services and three actual businesses that offer products.
-  Describe the internal role of accounting for organizations.
- Identify three types of services typically offered by accounting professionals.
-  What type of accounting information might be useful to the marketing managers of a business?
- Why is accounting described as a service activity?
- What are some accounting-related professions?
- How do ethics rules affect auditors' choice of clients?
- What work do tax accounting professionals perform in addition to preparing tax returns?
- What does the concept of *objectivity* imply for information reported in financial statements? Why?
- A business reports its own office stationery on the balance sheet at its \$400 cost, although it cannot be sold for more than \$10 as scrap paper. Which accounting principle and/or assumption justifies this treatment?
- Why is the revenue recognition principle needed? What does it demand?
- Describe the three basic forms of business organization and their key attributes.
- Define (a) *assets*, (b) *liabilities*, (c) *equity*, and (d) *net assets*.
- What events or transactions change equity?
- Identify the two main categories of accounting principles.
- What do accountants mean by the term *revenue*?
- Define *net income* and explain its computation.
- Identify the four basic financial statements of a business.
-  What information is reported in an income statement?
- Give two examples of expenses a business might incur.
- What is the purpose of the statement of retained earnings?
-  What information is reported in a balance sheet?
- The statement of cash flows reports on what major activities?
-  Define and explain return on assets.
- ^A Define return and risk. Discuss the trade-off between them.
- ^BDescribe the three major business activities in organizations.
- ^BExplain why investing (assets) and financing (liabilities and equity) totals are always equal.
- Refer to the financial statements of **Research In Motion** in Appendix A near the end of the book. To what level of significance are dollar amounts rounded? What time period does its income statement cover?
- Identify the dollar amounts of **Apple's** 2009 assets, liabilities, and equity as reported in its statements in Appendix A near the end of the book.
- Refer to **Nokia's** balance sheet in Appendix A near the end of the book. Confirm that its total assets equal its total liabilities plus total equity.
-  Access the SEC EDGAR database (www.sec.gov) and retrieve **Palm's** 2009 10-K (filed July 24, 2009; ticker PALM). Identify its auditor. What responsibility does its independent auditor claim regarding Palm's financial statements?

Quick Study exercises give readers a brief test of key elements.

Connect reproduces assignments online, in static or algorithmic mode, which allows instructors to monitor, promote, and assess student learning. It can be used for practice, homework, or exams.



QUICK STUDY

QS 1-1

Identifying accounting terms 

Reading and interpreting accounting reports requires some knowledge of accounting terminology.
 (a) Identify the meaning of these accounting-related acronyms: GAAP, SEC, FASB, IASB and IFRS.
 (b) Briefly explain the importance of the knowledge base or organization that is referred to for each of the accounting-related acronyms.



An important responsibility of many accounting professionals is to design and implement internal control procedures for organizations. Explain the purpose of internal control procedures. Provide two examples of internal controls applied by companies.

QS 1-2
Explaining internal control
C1

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


- a. Lenders d. Sales staff g. Brokers j. Managers
- b. Controllers e. FBI and IRS h. Suppliers k. Business press
- c. Shareholders f. Consumer group i. Customers l. District attorney

QS 1-3
Identifying accounting users
C2

There are many job opportunities for those with accounting knowledge. Identify at least three main areas of opportunities for accounting professionals. For each area, identify at least three job possibilities linked to accounting.


QS 1-4
Accounting opportunities C2

Accounting professionals must sometimes choose between two or more acceptable methods of accounting for business transactions and events. Explain why these situations can involve difficult matters of ethical concern.


QS 1-5
Identifying ethical concerns C3
 This icon highlights assignments that enhance decision-making skills.

Identify which accounting principle or assumption best describes each of the following practices:

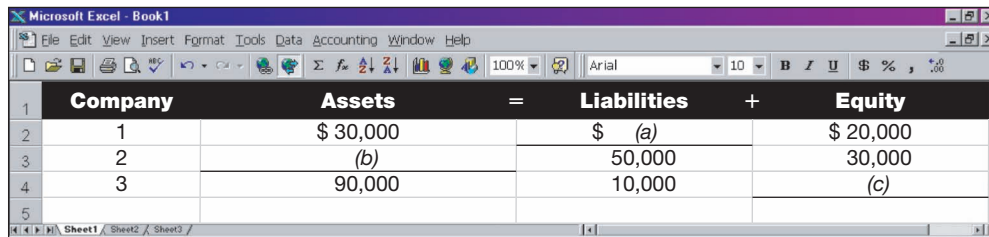
- a. If \$51,000 cash is paid to buy land, the land is reported on the buyer's balance sheet at \$51,000.
- b. Alissa Kees owns both Sailing Passions and Dockside Supplies. In preparing financial statements for Dockside Supplies, Kees makes sure that the expense transactions of Sailing Passions are kept separate from Dockside's transactions and financial statements.
- c. In December 2010, Ace Landscaping received a customer's order and cash prepayment to install sod at a new house that would not be ready for installation until March 2011. Ace should record the revenue from the customer order in March 2011, not in December 2010.

QS 1-6
Identifying accounting principles
C4 

- a. Total assets of Caldwell Company equal \$40,000 and its equity is \$10,000. What is the amount of its liabilities?
- b. Total assets of Waterworld equal \$55,000 and its liabilities and equity amounts are equal to each other. What is the amount of its liabilities? What is the amount of its equity?

QS 1-7
Applying the accounting equation
A1 

Use the accounting equation to compute the missing financial statement amounts (a), (b), and (c).



Company	Assets	=	Liabilities	+	Equity
1	\$ 30,000		\$ (a)		\$ 20,000
2	(b)		50,000		30,000
3	90,000		10,000		(c)


QS 1-8
Applying the accounting equation
A1

Accounting provides information about an organization's business transactions and events that both affect the accounting equation and can be reliably measured. Identify at least two examples of both (a) business transactions and (b) business events that meet these requirements.

QS 1-9
Identifying transactions and events P1

Use Apple's September 26, 2009, financial statements, in Appendix A near the end of the book, to answer the following:

- a. Identify the dollar amounts of Apple's 2009 (1) assets, (2) liabilities, and (3) equity.
- b. Using Apple's amounts from part a, verify that Assets = Liabilities + Equity.

QS 1-10
Identifying and computing assets, liabilities, and equity
P1 



QS 1-11

Computing and interpreting return on assets



In a recent year's financial statements, **Home Depot** reported the following results. Compute and interpret Home Depot's return on assets (assume competitors average a 5% return on assets).

Sales	\$71,288 million
Net income	2,260 million
Average total assets	42,744 million

QS 1-12

Identifying items with financial statements



Indicate in which financial statement each item would most likely appear: income statement (I), balance sheet (B), statement of retained earnings (RE), or statement of cash flows (CF).

- a. Assets
- b. Revenues
- c. Liabilities
- d. Equipment
- e. Dividends
- f. Expenses
- g. Total liabilities and equity
- h. Cash from operating activities
- i. Net decrease (or increase) in cash

QS 1-13

International accounting standards C4



This icon highlights assignments that focus on IFRS-related content.

Answer each of the following questions related to international accounting standards.

- a. The International Accounting Standards Board (IASB) issues preferred accounting practices that are referred to as what?
- b. The FASB and IASB are working on a convergence process for what purpose?
- c. The SEC has proposed a roadmap for use of IFRS by U.S. companies. What is the proposed adoption date for large U.S. companies to adopt IFRS?



EXERCISES

Exercise 1-1

Classifying activities reflected in the accounting system



Accounting is an information and measurement system that identifies, records, and communicates relevant, reliable, and comparable information about an organization's business activities. Classify the following activities as part of the identifying (I), recording (R), or communicating (C) aspects of accounting.

- _____ 1. Determining employee tasks behind a service.
- _____ 2. Establishing revenues generated from a product.
- _____ 3. Maintaining a log of service costs.
- _____ 4. Measuring the costs of a product.
- _____ 5. Preparing financial statements.
- _____ 6. Analyzing and interpreting reports.
- _____ 7. Presenting financial information.

Exercise 1-2

Identifying accounting users and uses



Part A. Identify the following users of accounting information as either an internal (I) or an external (E) user.

- _____ 1. Shareholders
- _____ 2. Creditors
- _____ 3. Nonexecutive employee
- _____ 4. Research and development director
- _____ 5. Purchasing manager
- _____ 6. Human resources director
- _____ 7. Production supervisors
- _____ 8. Distribution managers

Part B. Identify the following questions as most likely to be asked by an internal (I) or an external (E) user of accounting information.

- _____ 1. What are the costs of our service to customers?
- _____ 2. Should we make a five-year loan to that business?
- _____ 3. Should we spend further research on our product?
- _____ 4. Do income levels justify the current stock price?
- _____ 5. What are reasonable payroll benefits and wages?
- _____ 6. Which firm reports the highest sales and income?
- _____ 7. What are the costs of our product's ingredients?

Exercise 1-3

Describing accounting responsibilities



Many accounting professionals work in one of the following three areas:

- A. Managerial accounting** **B. Financial accounting** **C. Tax accounting**
- Identify the area of accounting that is most involved in each of the following responsibilities:
- _____ 1. Reviewing reports for SEC compliance.
 - _____ 2. Planning transactions to minimize taxes.
 - _____ 3. Investigating violations of tax laws.
 - _____ 4. Preparing external financial statements.
 - _____ 5. Budgeting.
 - _____ 6. Cost accounting.
 - _____ 7. External auditing.
 - _____ 8. Internal auditing.



Assume the following role and describe a situation in which ethical considerations play an important part in guiding your decisions and actions:

- You are a student in an introductory accounting course.
- You are an accounting professional with audit clients that are competitors in business.
- You are an accounting professional preparing tax returns for clients.
- You are a manager with responsibility for several employees.

Exercise 1-4

Identifying ethical concerns



Match each of the numbered descriptions with the term or phrase it best reflects. Indicate your answer by writing the letter for the term or phrase in the blank provided.

- | | | | |
|-----------------|--------------------------|------------------------------|----------------------|
| A. Audit | C. Ethics | E. SEC | G. Net income |
| B. GAAP | D. Tax accounting | F. Public accountants | H. IASB |

- Amount a business earns after paying all expenses and costs associated with its sales and revenues.
- An examination of an organization's accounting system and records that adds credibility to financial statements.
- Principles that determine whether an action is right or wrong.
- Accounting professionals who provide services to many clients.
- An accounting area that includes planning future transactions to minimize taxes paid.

Exercise 1-5

Learning the language of business

C1–C3

Match each of the numbered descriptions with the principle or assumption it best reflects. Enter the letter for the appropriate principle or assumption in the blank space next to each description.

- | | |
|---|---|
| A. Cost principle | E. General accounting principle |
| B. Matching principle | F. Business entity assumption |
| C. Specific accounting principle | G. Revenue recognition principle |
| D. Full disclosure principle | H. Going-concern assumption |

- Revenue is recorded only when the earnings process is complete.
- Information is based on actual costs incurred in transactions.
- Usually created by a pronouncement from an authoritative body.
- Financial statements reflect the assumption that the business continues operating.
- A company reports details behind financial statements that would impact users' decisions.
- A company records the expenses incurred to generate the revenues reported.
- Derived from long-used and generally accepted accounting practices.
- Every business is accounted for separately from its owner or owners.

Exercise 1-6

Identifying accounting principles and assumptions

C4

The following describe several different business organizations. Determine whether the description refers to a sole proprietorship, partnership, or corporation.

- A-1 pays its own income taxes and has two owners.
- Ownership of Zeller Company is divided into 1,000 shares of stock.
- Waldron is owned by Mary Malone, who is personally liable for the company's debts.
- Micah Douglas and Nathan Logan own Financial Services, a financial services provider. Neither Douglas nor Logan has personal responsibility for the debts of Financial Services.
- Bailey and Kay own Squeaky Clean, a cleaning service. Both are personally liable for the debts of the business.
- Plasto Products does not pay income taxes and has one owner.
- Ian LLC does not have separate legal existence apart from the one person who owns it.

Exercise 1-7

Distinguishing business organizations

C4

Answer the following questions. (*Hint:* Use the accounting equation.)

- Office Mart has assets equal to \$123,000 and liabilities equal to \$53,000 at year-end. What is the total equity for Office Mart at year-end?
- At the beginning of the year, Logan Company's assets are \$200,000 and its equity is \$150,000. During the year, assets increase \$70,000 and liabilities increase \$30,000. What is the equity at the end of the year?
- At the beginning of the year, Keller Company's liabilities equal \$60,000. During the year, assets increase by \$80,000, and at year-end assets equal \$180,000. Liabilities decrease \$10,000 during the year. What are the beginning and ending amounts of equity?

Exercise 1-8

Using the accounting equation

**Check** (c) Beg. equity, \$40,000



Exercise 1-9

Using the accounting equation

A1

Determine the missing amount from each of the separate situations *a*, *b*, and *c* below.

	Assets		=	Liabilities		+	Equity	
1								
2	(a)	\$?			\$ 30,000			\$ 65,000
3	(b)	89,000			22,000			?
4	(c)	132,000			?			20,000
5								

Exercise 1-10

Identifying effects of transactions on the accounting equation

P1

Provide an example of a transaction that creates the described effects for the separate cases *a* through *g*.

- a. Increases an asset and decreases an asset.
- b. Decreases an asset and decreases a liability.
- c. Decreases a liability and increases a liability.
- d. Increases an asset and increases a liability.
- e. Decreases an asset and decreases equity.
- f. Increases a liability and decreases equity.
- g. Increases an asset and increases equity.

Exercise 1-11

Identifying effects of transactions using the accounting equation

P1

Lena Gold began a professional practice on June 1 and plans to prepare financial statements at the end of each month. During June, Gold (the owner) completed these transactions:

- a. Owner invested \$50,000 cash in the company along with equipment that had a \$10,000 market value in exchange for common stock.
- b. The company paid \$1,600 cash for rent of office space for the month.
- c. The company purchased \$12,000 of additional equipment on credit (payment due within 30 days).
- d. The company completed work for a client and immediately collected the \$2,000 cash earned.
- e. The company completed work for a client and sent a bill for \$7,000 to be received within 30 days.
- f. The company purchased additional equipment for \$8,000 cash.
- g. The company paid an assistant \$2,400 cash as wages for the month.
- h. The company collected \$5,000 cash as a partial payment for the amount owed by the client in transaction *e*.
- i. The company paid \$12,000 cash to settle the liability created in transaction *c*.
- j. The company paid \$500 cash for dividends.

Required

Create a table like the one in Exhibit 1.9, using the following headings for columns: Cash; Accounts Receivable; Equipment; Accounts Payable; Common Stock; Dividends; Revenues; and Expenses. Then use additions and subtractions to show the effects of the transactions on individual items of the accounting equation. Show new balances after each transaction.

Check Net income, \$5,000

Exercise 1-12

Analysis using the accounting equation

P1

Zelda began a new consulting firm on January 5. The accounting equation showed the following balances after each of the company's first five transactions. Analyze the accounting equation for each transaction and describe each of the five transactions with their amounts.

Transaction	Assets					=	Liabilities		+	Equity			
	Cash	+	Accounts Receivable	+	Office Supplies	+	Office Furniture	=	Accounts Payable	+	Common Stock	+	Revenues
a.	\$20,000	+	\$ 0	+	\$ 0	+	\$ 0	=	\$ 0	+	\$20,000	+	\$ 0
b.	19,000	+	0	+	1,500	+	0	=	500	+	20,000	+	0
c.	11,000	+	0	+	1,500	+	8,000	=	500	+	20,000	+	0
d.	11,000	+	3,000	+	1,500	+	8,000	=	500	+	20,000	+	3,000
e.	11,500	+	3,000	+	1,500	+	8,000	=	500	+	20,000	+	3,500



The following table shows the effects of five transactions (*a* through *e*) on the assets, liabilities, and equity of Vera's Boutique. Write short descriptions of the probable nature of each transaction.

Assets				=	Liabilities	+	Equity	
Cash	+ Accounts Receivable	+ Office Supplies	+ Land	=	Accounts Payable	+ Common Stock	+ Revenues	
\$ 10,500	+ \$ 0	+ \$ 1,500	+ \$ 9,500	=	\$ 0	+ \$ 21,500	+ \$ 0	
a. - 2,000			+ 2,000	=				
b.		+ 500		=	+ 500			
c.	+ 950			=			+ 950	
d. - 500				=	- 500			
e. + 950	- 950			=				
<u>\$ 8,950</u>	+ <u>\$ 0</u>	+ <u>\$ 2,000</u>	+ <u>\$ 11,500</u>	=	<u>\$ 0</u>	+ <u>\$ 21,500</u>	+ <u>\$ 950</u>	

Exercise 1-13
Identifying effects of transactions on accounting equation



On October 1, Natalie King organized Real Solutions, a new consulting firm. On October 31, the company's records show the following items and amounts. Use this information to prepare an October income statement for the business.

Cash	\$ 2,000	Cash dividends	\$ 3,360
Accounts receivable	13,000	Consulting fees earned	15,000
Office supplies	4,250	Rent expense	2,550
Land	36,000	Salaries expense	6,000
Office equipment	28,000	Telephone expense	660
Accounts payable	7,500	Miscellaneous expenses	680
Common stock	74,000		

Exercise 1-14
Preparing an income statement
P2

Use the information in Exercise 1-14 to prepare an October statement of retained earnings for Real Solutions.


Exercise 1-15
Preparing a statement of retained earnings P2

Use the information in Exercise 1-14 (if completed, you can also use your solution to Exercise 1-15) to prepare an October 31 balance sheet for Real Solutions.

Exercise 1-16
Preparing a balance sheet P2


Use the information in Exercise 1-14 to prepare an October 31 statement of cash flows for Real Solutions. Also assume the following:

- The owner's initial investment consists of \$38,000 cash and \$36,000 in land in exchange for common stock.
- The company's \$28,000 equipment purchase is paid in cash.
- The accounts payable balance of \$7,500 consists of the \$4,250 office supplies purchase and \$3,250 in employee salaries yet to be paid.
- The company's rent, telephone, and miscellaneous expenses are paid in cash.
- \$2,000 has been collected on the \$15,000 consulting fees earned.

Exercise 1-17
Preparing a statement of cash flows
P2 

Check Net increase in cash, \$2,000

Geneva Group reports net income of \$20,000 for 2011. At the beginning of 2011, Geneva Group had \$100,000 in assets. By the end of 2011, assets had grown to \$150,000. What is Geneva Group's 2011 return on assets? How would you assess its performance if competitors average a 10% return on assets?

Exercise 1-18
Analysis of return on assets
A2 

Indicate the section where each of the following would appear on the statement of cash flows.

- | | | |
|--|--|--|
| A. Cash flows from operating activity | | |
| B. Cash flows from investing activity | | |
| C. Cash flows from financing activity | | |
| _____ 1. Cash paid for wages | _____ 5. Cash paid on an account payable | |
| _____ 2. Cash paid for dividends | _____ 6. Cash received from stock issued | |
| _____ 3. Cash purchase of equipment | _____ 7. Cash received from clients | |
| _____ 4. Cash paid for advertising | _____ 8. Cash paid for rent | |

Exercise 1-19
Identifying sections of the statement of cash flows
P2



Exercise 1-20^B

Identifying business activities

C5

Match each transaction or event to one of the following activities of an organization: financing activities (F), investing activities (I), or operating activities (O).

1. _____ An owner contributes resources to the business in exchange for stock.
2. _____ An organization purchases equipment.
3. _____ An organization advertises a new product.
4. _____ The organization borrows money from a bank.
5. _____ An organization sells some of its land.

Exercise 1-21

Preparing an income statement for a global company

P2



Nintendo Company reports the following income statement accounts for the year ended March 31, 2009. (Japanese yen in millions.)

Net sales	¥1,838,622
Cost of sales	1,044,981
Selling, general and administrative expenses	238,378
Other expenses	276,174

Use this information to prepare Nintendo’s income statement for the year ended March 31, 2009.

Problem Set B located at the end of Problem Set A is provided for each problem to reinforce the learning process.



PROBLEM SET A

Problem 1-1A

Identifying effects of transactions on financial statements

A1 P1



Identify how each of the following separate transactions affects financial statements. For the balance sheet, identify how each transaction affects total assets, total liabilities, and total equity. For the income statement, identify how each transaction affects net income. For the statement of cash flows, identify how each transaction affects cash flows from operating activities, cash flows from financing activities, and cash flows from investing activities. For increases, place a “+” in the column or columns. For decreases, place a “-” in the column or columns. If both an increase and a decrease occur, place a “+/-” in the column or columns. The first transaction is completed as an example.

	Transaction	Balance Sheet			Income Statement	Statement of Cash Flows		
		Total Assets	Total Liab.	Total Equity	Net Income	Operating Activities	Financing Activities	Investing Activities
1	Owner invests cash for stock	+		+			+	
2	Incurs legal costs on credit							
3	Pays cash for employee wages							
4	Borrows cash by signing long-term note payable							
5	Receives cash for services provided							
6	Buys land by signing note payable							
7	Buys office equipment for cash							
8	Provides services on credit							
9	Collects cash on receivable from (8)							
10	Pays cash dividend							



The following financial statement information is from five separate companies:

	Company A	Company B	Company C	Company D	Company E
December 31, 2010					
Assets	\$45,000	\$35,000	\$29,000	\$80,000	\$123,000
Liabilities	23,500	22,500	14,000	38,000	?
December 31, 2011					
Assets	48,000	41,000	?	125,000	112,500
Liabilities	?	27,500	19,000	64,000	75,000
During year 2011					
Stock issuances	5,000	1,500	7,750	?	4,500
Net income (loss)	7,500	?	9,000	12,000	18,000
Cash dividends	2,500	3,000	3,875	0	9,000

Required

- Answer the following questions about Company A:
 - What is the amount of equity on December 31, 2010?
 - What is the amount of equity on December 31, 2011?
 - What is the amount of liabilities on December 31, 2011?
- Answer the following questions about Company B:
 - What is the amount of equity on December 31, 2010?
 - What is the amount of equity on December 31, 2011?
 - What is net income for year 2011?
- Calculate the amount of assets for Company C on December 31, 2011.
- Calculate the amount of stock issuances for Company D during year 2011.
- Calculate the amount of liabilities for Company E on December 31, 2010.

Problem 1-2A

Computing missing information using accounting knowledge

A1 P1



Check (1b) \$31,500

(2c) \$2,500

(3) \$46,875

The following is selected financial information for Affiliated Company as of December 31, 2011: liabilities, \$34,000; equity, \$56,000; assets, \$90,000.

Required

Prepare the balance sheet for Affiliated Company as of December 31, 2011.

Problem 1-3A

Preparing a balance sheet

P2

The following is selected financial information for Sun Energy Company for the year ended December 31, 2011: revenues, \$65,000; expenses, \$50,000; net income, \$15,000.

Required

Prepare the 2011 calendar-year income statement for Sun Energy Company.

Problem 1-4A

Preparing an income statement

P2

Following is selected financial information for Boardwalk for the year ended December 31, 2011.

Retained earnings, Dec. 31, 2011	\$15,000	Cash dividends	\$2,000
Net income	9,000	Retained earnings, Dec. 31, 2010	8,000

Required

Prepare the 2011 statement of retained earnings for Boardwalk.

Problem 1-5A

Preparing a statement of retained earnings

P2

**Problem 1-6A**

Preparing a statement of cash flows

P2

Check Cash balance, Dec. 31, 2011, \$3,500

Problem 1-7A

Analyzing effects of transactions

C4 P1 P2 A1

Check (2) Ending balances: Cash, \$9,200; Expenses, \$3,500; Notes Payable, \$250,000

(3) Net income, \$8,500

Problem 1-8A

Analyzing transactions and preparing financial statements

C4 P1 P2



mhhe.com/wildFA6e

Following is selected financial information of Trimark for the year ended December 31, 2011.

Cash used by investing activities	\$(3,000)
Net increase in cash	200
Cash used by financing activities	(3,800)
Cash from operating activities	7,000
Cash, December 31, 2010	3,300

Required

Prepare the 2011 statement of cash flows for Trimark Company.

Miranda Right started Right Consulting, a new business, and completed the following transactions during its first year of operations.

- a. M. Right invests \$60,000 cash and office equipment valued at \$30,000 in the company in exchange for common stock.
- b. The company purchased a \$300,000 building to use as an office. Right paid \$50,000 in cash and signed a note payable promising to pay the \$250,000 balance over the next 10 years.
- c. The company purchased office equipment for \$6,000 cash.
- d. The company purchased \$4,000 of office supplies and \$1,000 of office equipment on credit.
- e. The company paid a local newspaper \$1,000 cash for printing an announcement of the office's opening.
- f. The company completed a financial plan for a client and billed that client \$4,000 for the service.
- g. The company designed a financial plan for another client and immediately collected an \$8,000 cash fee.
- h. The company paid \$1,800 cash for dividends.
- i. The company received \$3,000 cash as partial payment from the client described in transaction *f*.
- j. The company made a partial payment of \$500 cash on the equipment purchased in transaction *d*.
- k. The company paid \$2,500 cash for the office secretary's wages for this period.

Required

1. Create a table like the one in Exhibit 1.9, using the following headings for the columns: Cash; Accounts Receivable; Office Supplies; Office Equipment; Building; Accounts Payable; Notes Payable; Common Stock; Dividends; Revenues; and Expenses.
2. Use additions and subtractions within the table created in part 1 to show the dollar effects of each transaction on individual items of the accounting equation. Show new balances after each transaction.
3. Once you have completed the table, determine the company's net income.

J. D. Simpson started The Simpson Co., a new business that began operations on May 1. The Simpson Co. completed the following transactions during its first month of operations.

- May 1 J. D. Simpson invested \$60,000 cash in the company in exchange for common stock.
- 1 The company rented a furnished office and paid \$3,200 cash for May's rent.
- 3 The company purchased \$1,680 of office equipment on credit.
- 5 The company paid \$800 cash for this month's cleaning services.
- 8 The company provided consulting services for a client and immediately collected \$4,600 cash.
- 12 The company provided \$3,000 of consulting services for a client on credit.
- 15 The company paid \$850 cash for an assistant's salary for the first half of this month.
- 20 The company received \$3,000 cash payment for the services provided on May 12.
- 22 The company provided \$2,800 of consulting services on credit.
- 25 The company received \$2,800 cash payment for the services provided on May 22.
- 26 The company paid \$1,680 cash for the office equipment purchased on May 3.
- 27 The company purchased \$60 of advertising in this month's (May) local paper on credit; cash payment is due June 1.
- 28 The company paid \$850 cash for an assistant's salary for the second half of this month.
- 30 The company paid \$200 cash for this month's telephone bill.
- 30 The company paid \$480 cash for this month's utilities.
- 31 The company paid \$1,200 cash for dividends.

Required

1. Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Office Equipment; Accounts Payable; Common Stock; Dividends; Revenues; and Expenses.



2. Show effects of the transactions on the accounts of the accounting equation by recording increases and decreases in the appropriate columns. Do not determine new account balances after each transaction. Determine the final total for each account and verify that the equation is in balance.
3. Prepare an income statement for May, a statement of retained earnings for May, a May 31 balance sheet, and a statement of cash flows for May.

Check (2) Ending balances: Cash, \$61,140; Expenses, \$6,440


(3) Net income, \$3,960;
Total assets, \$62,820

Curtis Hamilton started a new business and completed these transactions during December.

- Dec. 1 Curtis Hamilton transferred \$56,000 cash from a personal savings account to a checking account in the name of Hamilton Electric in exchange for common stock.
- 2 The company rented office space and paid \$800 cash for the December rent.
 - 3 The company purchased \$14,000 of electrical equipment by paying \$3,200 cash and agreeing to pay the \$10,800 balance in 30 days.
 - 5 The company purchased office supplies by paying \$900 cash.
 - 6 The company completed electrical work and immediately collected \$1,000 cash for these services.
 - 8 The company purchased \$3,800 of office equipment on credit.
 - 15 The company completed electrical work on credit in the amount of \$4,000.
 - 18 The company purchased \$500 of office supplies on credit.
 - 20 The company paid \$3,800 cash for the office equipment purchased on December 8.
 - 24 The company billed a client \$600 for electrical work completed; the balance is due in 30 days.
 - 28 The company received \$4,000 cash for the work completed on December 15.
 - 29 The company paid the assistant's salary of \$1,200 cash for this month.
 - 30 The company paid \$440 cash for this month's utility bill.
 - 31 The company paid \$700 cash for dividends.

Problem 1-9A

Analyzing transactions and preparing financial statements

C4 P1 P2 



mhhe.com/wildFA6e

Required

1. Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Office Supplies; Office Equipment; Electrical Equipment; Accounts Payable; Common Stock; Dividends; Revenues; and Expenses.
2. Use additions and subtractions to show the effects of each transaction on the accounts in the accounting equation. Show new balances after each transaction.
3. Use the increases and decreases in the columns of the table from part 2 to prepare an income statement, a statement of retained earnings, and a statement of cash flows—each of these for the current month. Also prepare a balance sheet as of the end of the month.

Check (2) Ending balances: Cash, \$49,960, Accounts Payable, \$11,300

(3) Net income, \$3,160;
Total assets, \$69,760

Analysis Component

4. Assume that the owner investment transaction on December 1 was \$40,000 cash instead of \$56,000 and that Hamilton Electric obtained another \$16,000 in cash by borrowing it from a bank. Explain the effect of this change on total assets, total liabilities, and total equity.

Nolan manufactures, markets, and sells cellular telephones. The average total assets for Nolan is \$250,000. In its most recent year, Nolan reported net income of \$55,000 on revenues of \$455,000.

Required

1. What is Nolan's return on assets?
2. Does return on assets seem satisfactory for Nolan given that its competitors average a 12% return on assets?
3. What are total expenses for Nolan in its most recent year?
4. What is the average total amount of liabilities plus equity for Nolan?

Problem 1-10A

Determining expenses, liabilities, equity, and return on assets

A1 A2 

Check (3) \$400,000
(4) \$250,000

Coca-Cola and **PepsiCo** both produce and market beverages that are direct competitors. Key financial figures (in \$ millions) for these businesses over the past year follow.

Key Figures (\$ millions)	Coca-Cola	PepsiCo
Sales	\$30,990	\$43,232
Net income	6,906	5,979
Average assets	44,595	37,921

Problem 1-11A

Computing and interpreting return on assets

A2 



Check (1a) 15.5%; (1b) 15.8%

Required

1. Compute return on assets for (a) Coca-Cola and (b) PepsiCo.
2. Which company is more successful in its total amount of sales to consumers?
3. Which company is more successful in returning net income from its assets invested?

Analysis Component

4. Write a one-paragraph memorandum explaining which company you would invest your money in and why. (Limit your explanation to the information provided.)

Problem 1-12A^A

Identifying risk and return



All business decisions involve aspects of risk and return.

Required

Identify both the risk and the return in each of the following activities:

1. Investing \$1,000 in a 4% savings account.
2. Placing a \$1,000 bet on your favorite sports team.
3. Investing \$10,000 in Yahoo! stock.
4. Taking out a \$10,000 college loan to earn an accounting degree.

Problem 1-13A^B

Describing organizational activities C5

An organization undertakes various activities in pursuit of business success. Identify an organization's three major business activities, and describe each activity.

Problem 1-14A^B

Describing organizational activities C5

A start-up company often engages in the following transactions in its first year of operations. Classify those transactions in one of the three major categories of an organization's business activities.

F. Financing **I.** Investing **O.** Operating

- | | |
|--|---|
| _____ 1. Owner investing land in business. | _____ 5. Purchasing equipment. |
| _____ 2. Purchasing a building. | _____ 6. Selling and distributing products. |
| _____ 3. Purchasing land. | _____ 7. Paying for advertising. |
| _____ 4. Borrowing cash from a bank. | _____ 8. Paying employee wages. |

PROBLEM SET B

Problem 1-1B

Identifying effects of transactions on financial statements A1 P1

Identify how each of the following separate transactions affects financial statements. For the balance sheet, identify how each transaction affects total assets, total liabilities, and total equity. For the income statement, identify how each transaction affects net income. For the statement of cash flows, identify how each transaction affects cash flows from operating activities, cash flows from financing activities, and cash flows from investing activities. For increases, place a "+" in the column or columns. For decreases, place a "-" in the column or columns. If both an increase and a decrease occur, place "+/-" in the column or columns. The first transaction is completed as an example.

	Transaction	Balance Sheet			Income Statement	Statement of Cash Flows		
		Total Assets	Total Liab.	Total Equity	Net Income	Operating Activities	Financing Activities	Investing Activities
1	Owner invests cash for stock	+		+			+	
2	Buys building by signing note payable							
3	Pays cash for salaries incurred							
4	Provides services for cash							
5	Pays cash for rent incurred							
6	Incurs utilities costs on credit							
7	Buys store equipment for cash							
8	Pays cash dividend							
9	Provides services on credit							
10	Collects cash on receivable from (9)							



The following financial statement information is from five separate companies.

	Company V	Company W	Company X	Company Y	Company Z
December 31, 2010					
Assets	\$45,000	\$70,000	\$121,500	\$82,500	\$124,000
Liabilities	30,000	50,000	58,500	61,500	?
December 31, 2011					
Assets	49,000	90,000	136,500	?	160,000
Liabilities	26,000	?	55,500	72,000	52,000
During year 2011					
Stock issuances	6,000	10,000	?	38,100	40,000
Net income or (loss)	?	30,000	16,500	24,000	32,000
Cash dividends	4,500	2,000	0	18,000	6,000

Required

- Answer the following questions about Company V:
 - What is the amount of equity on December 31, 2010?
 - What is the amount of equity on December 31, 2011?
 - What is the net income or loss for the year 2011?
- Answer the following questions about Company W:
 - What is the amount of equity on December 31, 2010?
 - What is the amount of equity on December 31, 2011?
 - What is the amount of liabilities on December 31, 2011?
- Calculate the amount of stock issuances for Company X during 2011.
- Calculate the amount of assets for Company Y on December 31, 2011.
- Calculate the amount of liabilities for Company Z on December 31, 2010.

Problem 1-2B

Computing missing information using accounting knowledge

A1 P1



Check (1b) \$23,000

(2c) \$32,000

(4) \$137,100

The following is selected financial information for RWB Company as of December 31, 2011.

Liabilities	\$74,000	Equity	\$40,000	Assets	\$114,000
-------------------	----------	--------------	----------	--------------	-----------

Required

Prepare the balance sheet for RWB Company as of December 31, 2011.

Problem 1-3B

Preparing a balance sheet

P2

Selected financial information for Online Company for the year ended December 31, 2011, follows.

Revenues	\$58,000	Expenses	\$30,000	Net income	\$28,000
----------------	----------	----------------	----------	------------------	----------

Required

Prepare the 2011 income statement for Online Company.

Problem 1-4B

Preparing an income statement

P2

Following is selected financial information of ComEx for the year ended December 31, 2011.

Retained earnings, Dec. 31, 2011	\$47,000	Cash dividends	\$ 8,000
Net income	6,000	Retained earnings, Dec. 31, 2010	49,000

Required

Prepare the 2011 statement of retained earnings for ComEx.

Problem 1-5B

Preparing a statement of retained earnings

P2

**Problem 1-6B**

Preparing a statement of cash flows

P2

Selected financial information of BuyRight Company for the year ended December 31, 2011, follows.

Cash from investing activities	\$2,600
Net increase in cash	1,400
Cash from financing activities	2,800
Cash used by operating activities	(4,000)
Cash, December 31, 2010	1,300

Required

Prepare the 2011 statement of cash flows for BuyRight Company.

Problem 1-7B

Analyzing effects of transactions

C4 P1 P2 A1

Tiana Moore started a new business, Tiana's Solutions, and completed the following transactions during its first year of operations.

- T. Moore invests \$95,000 cash and office equipment valued at \$20,000 in the company in exchange for common stock.
- The company purchased a \$120,000 building to use as an office. It paid \$20,000 in cash and signed a note payable promising to pay the \$100,000 balance over the next 10 years.
- The company purchased office equipment for \$20,000 cash.
- The company purchased \$1,400 of office supplies and \$3,000 of office equipment on credit.
- The company paid a local newspaper \$400 cash for printing an announcement of the office's opening.
- The company completed a financial plan for a client and billed that client \$1,800 for the service.
- The company designed a financial plan for another client and immediately collected a \$2,000 cash fee.
- The company paid \$5,000 cash for dividends.
- The company received \$1,800 cash from the client described in transaction *f*.
- The company made a payment of \$2,000 cash on the equipment purchased in transaction *d*.
- The company paid \$2,000 cash for the office secretary's wages.

Required

- Create a table like the one in Exhibit 1.9, using the following headings for the columns: Cash; Accounts Receivable; Office Supplies; Office Equipment; Building; Accounts Payable; Notes Payable; Common Stock; Dividends; Revenues; and Expenses.
- Use additions and subtractions within the table created in part 1 to show the dollar effects of each transaction on individual items of the accounting equation. Show new balances after each transaction.
- Once you have completed the table, determine the company's net income.

Check (2) Ending balances: Cash, \$49,400; Expenses, \$2,400; Notes Payable, \$100,000

(3) Net income, \$1,400

Problem 1-8B

Analyzing transactions and preparing financial statements

C4 P1 P2

Ken Stone launched a new business, Ken's Maintenance Co., that began operations on June 1. The following transactions were completed by the company during that first month.

- June 1 K. Stone invested \$120,000 cash in the company in exchange for common stock.
- 2 The company rented a furnished office and paid \$4,500 cash for June's rent.
- 4 The company purchased \$2,400 of equipment on credit.
- 6 The company paid \$1,125 cash for this month's advertising of the opening of the business.
- 8 The company completed maintenance services for a customer and immediately collected \$750 cash.
- 14 The company completed \$6,300 of maintenance services for City Center on credit.
- 16 The company paid \$900 cash for an assistant's salary for the first half of the month.
- 20 The company received \$6,300 cash payment for services completed for City Center on June 14.
- 21 The company completed \$3,500 of maintenance services for Skyway Co. on credit.
- 24 The company completed \$825 of maintenance services for Comfort Motel on credit.
- 25 The company received \$3,500 cash payment from Skyway Co. for the work completed on June 21.
- 26 The company made payment of \$2,400 cash for equipment purchased on June 4.
- 28 The company paid \$900 cash for an assistant's salary for the second half of this month.
- 29 The company paid \$2,000 cash for dividends.
- 30 The company paid \$120 cash for this month's telephone bill.
- 30 The company paid \$525 cash for this month's utilities.

Required

- Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Equipment; Accounts Payable; Common Stock; Dividends; Revenues; and Expenses.



- Show the effects of the transactions on the accounts of the accounting equation by recording increases and decreases in the appropriate columns. Do not determine new account balances after each transaction. Determine the final total for each account and verify that the equation is in balance.
- Prepare a June income statement, a June statement of retained earnings, a June 30 balance sheet, and a June statement of cash flows.

Check (2) Ending balances: Cash, \$118,080; Expenses, \$8,070

(3) Net income, \$3,305;
Total assets, \$121,305

Swender Excavating Co., owned by Patrick Swender, began operations in July and completed these transactions during that first month of operations.

- July
- P. Swender invested \$60,000 cash in the company in exchange for common stock.
 - The company rented office space and paid \$500 cash for the July rent.
 - The company purchased excavating equipment for \$4,000 by paying \$800 cash and agreeing to pay the \$3,200 balance in 30 days.
 - The company purchased office supplies for \$500 cash.
 - The company completed work for a customer and immediately collected \$2,200 cash for the work.
 - The company purchased \$3,800 of office equipment on credit.
 - The company completed work for a customer on credit in the amount of \$2,400.
 - The company purchased \$1,920 of office supplies on credit.
 - The company paid \$3,800 cash for the office equipment purchased on July 10.
 - The company billed a customer \$5,000 for work completed; the balance is due in 30 days.
 - The company received \$2,400 cash for the work completed on July 15.
 - The company paid an assistant's salary of \$1,260 cash for this month.
 - The company paid \$260 cash for this month's utility bill.
 - The company paid \$1,200 cash for dividends.

Required

- Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Office Supplies; Office Equipment; Excavating Equipment; Accounts Payable; Common Stock; Dividends; Revenues; and Expenses.
- Use additions and subtractions to show the effects of each transaction on the accounts in the accounting equation. Show new balances after each transaction.
- Use the increases and decreases in the columns of the table from part 2 to prepare an income statement, a statement of retained earnings, and a statement of cash flows—each of these for the current month. Also prepare a balance sheet as of the end of the month.

Analysis Component

- Assume that the \$4,000 purchase of excavating equipment on July 3 was financed from an owner investment of another \$4,000 cash in the business in exchange for more common stock (instead of the purchase conditions described in the transaction). Explain the effect of this change on total assets, total liabilities, and total equity.

Aspen Company manufactures, markets, and sells ATV and snowmobile equipment and accessories. The average total assets for Aspen is \$2,000,000. In its most recent year, Aspen reported net income of \$100,000 on revenues of \$1,200,000.

Required

- What is Aspen Company's return on assets?
- Does return on assets seem satisfactory for Aspen given that its competitors average a 9.5% return on assets?
- What are the total expenses for Aspen Company in its most recent year?
- What is the average total amount of liabilities plus equity for Aspen Company?

Problem 1-10B

Determining expenses, liabilities, equity, and return on assets

A1 A2

Check (3) \$1,100,000
(4) \$2,000,000

AT&T and **Verizon** produce and market telecommunications products and are competitors. Key financial figures (in \$ millions) for these businesses over the past year follow.

Key Figures (\$ millions)	AT&T	Verizon
Sales	\$123,018	\$107,808
Net income	12,535	10,358
Average assets	266,999	214,937

Problem 1-11B

Computing and interpreting return on assets

A2



Check (1a) 4.7%; (1b) 4.8%

Required

1. Compute return on assets for (a) AT&T and (b) Verizon.
2. Which company is more successful in the total amount of sales to consumers?
3. Which company is more successful in returning net income from its assets invested?

Analysis Component

4. Write a one-paragraph memorandum explaining which company you would invest your money in and why. (Limit your explanation to the information provided.)

Problem 1-12B^A

Identifying risk and return

A3



All business decisions involve aspects of risk and return.

Required

Identify both the risk and the return in each of the following activities:

1. Stashing \$1,000 cash under your mattress.
2. Placing a \$500 bet on a horse running in the Kentucky Derby.
3. Investing \$10,000 in Nike stock.
4. Investing \$10,000 in U.S. Savings Bonds.

Problem 1-13B^B

Describing organizational activities C5

Identify in outline format the three major business activities of an organization. For each of these activities, identify at least two specific transactions or events normally undertaken by the business's owners or its managers.

Problem 1-14B^B

Describing organizational activities C5

C5

A start-up company often engages in the following activities during its first year of operations. Classify each of the following activities into one of the three major activities of an organization.

- | A. Financing | B. Investing | C. Operating |
|-------------------------------------|---|--------------|
| _____ 1. Providing client services. | _____ 5. Supervising workers. | |
| _____ 2. Obtaining a bank loan. | _____ 6. Owner investing money in business. | |
| _____ 3. Purchasing machinery. | _____ 7. Renting office space. | |
| _____ 4. Research for its products. | _____ 8. Paying utilities expenses. | |

This serial problem starts in this chapter and continues throughout most chapters of the book. It is most readily solved if you use the Working Papers that accompany this book (but working papers are not required).

SERIAL PROBLEM

Business Solutions

C4 P1

SP 1 On October 1, 2011, Santana Rey launched a computer services company, **Business Solutions**, that is organized as a corporation and provides consulting services, computer system installations, and custom program development. Rey adopts the calendar year for reporting purposes and expects to prepare the company's first set of financial statements on December 31, 2011.

Required

Create a table like the one in Exhibit 1.9 using the following headings for columns: Cash; Accounts Receivable; Computer Supplies; Computer System; Office Equipment; Accounts Payable; Common Stock; Dividends; Revenues; and Expenses. Then use additions and subtractions within the table created to show the dollar effects for each of the following October transactions for Business Solutions on the individual items of the accounting equation. Show new balances after each transaction.

- Oct. 1 S. Rey invested \$45,000 cash, a \$20,000 computer system, and \$8,000 of office equipment in the company in exchange for common stock.
- 3 The company purchased \$1,420 of computer supplies on credit from Harris Office Products.
- 6 The company billed Easy Leasing \$4,800 for services performed in installing a new Web server.
- 8 The company paid \$1,420 cash for the computer supplies purchased from Harris Office Products on October 3.
- 10 The company hired Lyn Addie as a part-time assistant for \$125 per day, as needed.
- 12 The company billed Easy Leasing another \$1,400 for services performed.
- 15 The company received \$4,800 cash from Easy Leasing as partial payment toward its account.
- 17 The company paid \$805 cash to repair computer equipment damaged when moving it.
- 20 The company paid \$1,728 cash for advertisements published in the local newspaper.
- 22 The company received \$1,400 cash from Easy Leasing toward its account.
- 28 The company billed IFM Company \$5,208 for services performed.
- 31 The company paid \$875 cash for Lyn Addie's wages for seven days of work this month.
- 31 The company paid \$3,600 cash for dividends.

Check Ending balances: Cash, \$42,772; Revenues, \$11,408; Expenses, \$3,408


Beyond the Numbers (BTN) is a special problem section aimed to refine communication, conceptual, analysis, and research skills. It includes many activities helpful in developing an active learning environment.

Beyond the Numbers

BTN 1-1 Key financial figures for **Research In Motion**'s fiscal year ended February 27, 2010, follow.

Key Figure	In Millions
Liabilities + Equity	\$10,204
Net income	2,457
Revenues	14,953

REPORTING IN ACTION

A1 A2 A3 

RIM

Required

1. What is the total amount of assets invested in Research In Motion?
2. What is Research In Motion's return on assets? Its assets at February 28, 2009, equal \$8,101 (in millions).
3. How much are total expenses for Research In Motion for the year ended February 27, 2010?
4. Does Research In Motion's return on assets seem satisfactory if competitors average an 18% return?

Check (2) 26.8%


Fast Forward

5. Access Research In Motion's financial statements (Form 10-K) for fiscal years ending after February 27, 2010, from its Website (RIM.com) or from the SEC Website (www.SEC.gov) and compute its return on assets for those fiscal years. Compare the February 27, 2010, fiscal year-end return on assets to any subsequent years' returns you are able to compute, and interpret the results.

BTN 1-2 Key comparative figures (\$ millions) for both **Research In Motion** and **Apple** follow.

Key Figure	Research In Motion	Apple
Liabilities + Equity	\$10,204	\$47,501
Net income	2,457	8,235
Revenues and sales	14,953	42,905

COMPARATIVE ANALYSIS

A1 A2 A3 

RIM

Apple

Required

1. What is the total amount of assets invested in (a) Research In Motion and (b) Apple?
2. What is the return on assets for (a) Research In Motion and (b) Apple? Research In Motion's beginning-year assets equal \$8,101 (in millions) and Apple's beginning-year assets equal \$36,171 (in millions).
3. How much are expenses for (a) Research In Motion and (b) Apple?
4. Is return on assets satisfactory for (a) Research In Motion and (b) Apple? (Assume competitors average an 18% return.)
5. What can you conclude about Research In Motion and Apple from these computations?

Check (2b) 19.7%

BTN 1-3 Madison Thorne works in a public accounting firm and hopes to eventually be a partner. The management of Allnet Company invites Thorne to prepare a bid to audit Allnet's financial statements. In discussing the audit fee, Allnet's management suggests a fee range in which the amount depends on the reported profit of Allnet. The higher its profit, the higher will be the audit fee paid to Thorne's firm.

ETHICS CHALLENGE

C3 C4 

Required

1. Identify the parties potentially affected by this audit and the fee plan proposed.
2. What are the ethical factors in this situation? Explain.
3. Would you recommend that Thorne accept this audit fee arrangement? Why or why not?
4. Describe some ethical considerations guiding your recommendation.



COMMUNICATING IN PRACTICE

A1 C2  

BTN 1-4 Refer to this chapter's opening feature about **Twitter**. Assume that the owners desire to expand their online services to meet people's demands regarding online services. They eventually decide to meet with their banker to discuss a loan to allow Twitter to expand.

Required

1. Prepare a half-page report outlining the information you would request from the owners if you were the loan officer.
2. Indicate whether the information you request and your loan decision are affected by the form of business organization for Twitter.

TAKING IT TO THE NET

A2



BTN 1-5 Visit the EDGAR database at (www.sec.gov). Access the Form 10-K report of **Rocky Mountain Chocolate Factory** (ticker RMCF) filed on May 26, 2009, covering its 2009 fiscal year.

Required

1. Item 6 of the 10-K report provides comparative financial highlights of RMCF for the years 2005–2009. How would you describe the revenue trend for RMCF over this five-year period?
2. Has RMCF been profitable (see net income) over this five-year period? Support your answer.

TEAMWORK IN ACTION

C1

BTN 1-6 Teamwork is important in today's business world. Successful teams schedule convenient meetings, maintain regular communications, and cooperate with and support their members. This assignment aims to establish support/learning teams, initiate discussions, and set meeting times.

Required

1. Form teams and open a team discussion to determine a regular time and place for your team to meet between each scheduled class meeting. Notify your instructor via a memorandum or e-mail message as to when and where your team will hold regularly scheduled meetings.
2. Develop a list of telephone numbers and/or e-mail addresses of your teammates.

ENTREPRENEURIAL DECISION

A1 P1  

BTN 1-7 Refer to this chapter's opening feature about **Twitter**. Assume that the owners decide to open a new Website devoted to micro-blogging for accountants and those studying accounting. This new company will be called **AccounTwit**.

Required

1. AccounTwit obtains a \$500,000 loan and the three owners contribute \$250,000 in total from their own savings in exchange for common stock in the new company.
 - a. What is the new company's total amount of liabilities plus equity?
 - b. What is the new company's total amount of assets?
2. If the new company earns \$80,000 in net income in the first year of operation, compute its return on assets (assume average assets equal \$750,000). Assess its performance if competitors average a 10% return.

Check (2) 10.7%

HITTING THE ROAD

C2  

BTN 1-8 You are to interview a local business owner. (This can be a friend or relative.) Opening lines of communication with members of the business community can provide personal benefits of business networking. If you do not know the owner, you should call ahead to introduce yourself and explain your position as a student and your assignment requirements. You should request a 30-minute appointment for a face-to-face or phone interview to discuss the form of organization and operations of the business. Be prepared to make a good impression.

Required

1. Identify and describe the main operating activities and the form of organization for this business.
2. Determine and explain why the owner(s) chose this particular form of organization.
3. Identify any special advantages and/or disadvantages the owner(s) experiences in operating with this form of business organization.



BTN 1-9 **Nokia** (www.Nokia.com) is a leading manufacturer of mobile devices and services, and it competes to some extent with both **Research In Motion** and **Apple**. Key financial figures for Nokia follow.

Key Figure*	Euro (EUR) in Millions
Average assets	37,660
Net income	260
Revenue	40,984
Return on assets	0.7%

* Figures prepared in accordance with International Financial Reporting Standards.

GLOBAL DECISION

A1 A2 A3



NOKIA

RIM

Apple

Required

1. Identify any concerns you have in comparing Nokia's income and revenue figures to those of Research In Motion and Apple (in BTN 1-2) for purposes of making business decisions.
2. Identify any concerns you have in comparing Nokia's return on assets ratio to those of Research In Motion and Apple (computed for BTN 1-2) for purposes of making business decisions.

ANSWERS TO MULTIPLE CHOICE QUIZ

1. c; \$450,000 is the actual cost incurred.
2. b; revenue is recorded when earned.
3. d;
4. a
5. a

Assets	=	Liabilities	+	Equity
+\$100,000	=	+35,000	+	?

$$\text{Change in equity} = \$100,000 - \$35,000 = \underline{\underline{\$65,000}}$$