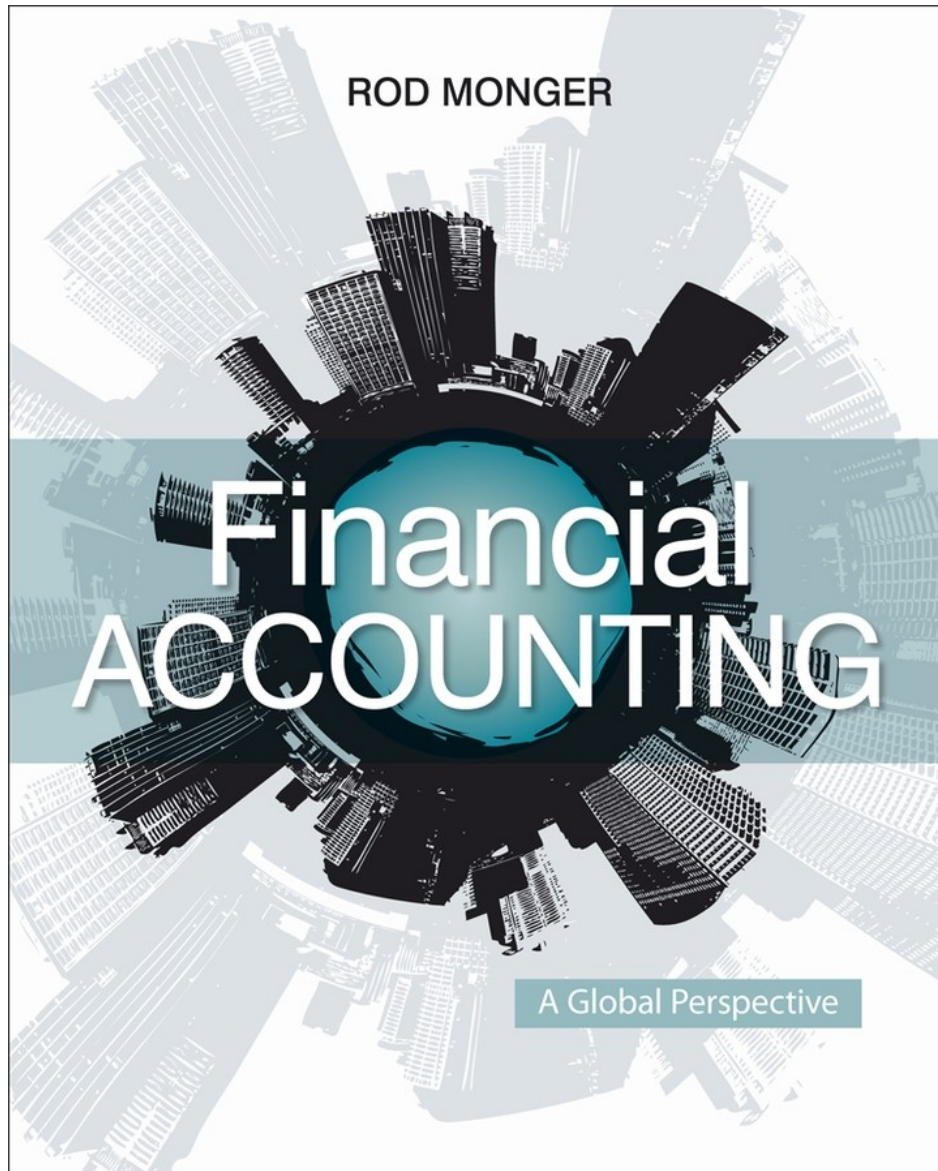




Instructor Manual

Chapter 1

The Financial Accounting Reporting System

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Lecture Notes

Introduction

This chapter was designed based on some of the ideas of Dr. Harvey J. Brightman who teaches a master university teaching program. Dr. Brightman believes that perhaps the most important element in students' perception of teaching quality is how organized the instructor is. Does the student understand what the 'big picture' is and how each topic fits into it? Dr. Brightman also believes that one of the best ways to convey the organization of the course is through what he refers to as a "visual scaffold."

The Financial Accounting Reporting System in this chapter is intended to provide this visual scaffold. Figure 1.9 introduces this visual based on only entities (the business, customers, suppliers and so forth) and external users. Then the Financial Accounting Reporting System is 'fleshed out' over the remainder of the chapter – in Figure 1.25, Figure 1.27, Figure 1.28 and finally the full version in Figure 1.30. Once students have the Financial Accounting Reporting System in mind, it should be much easier in the following chapters to demonstrate how the chapter topic fits into the overall scheme.

Dr. Brightman is also an advocate of the 'hook.' His view, which I share, is that students are not naturally curious and their appetite for the material at hand must be whetted. This can be done by demonstrating in a constructive way that the student does not know how to solve a particular type of problem and will be able to do so after learning the material. Or perhaps by demonstrating the usefulness of the material in a way student may not have thought about before.

I have used the second approach by discussing Warren Buffet's success in building Berkshire Hathaway. What I wanted to demonstrate is that whether a student chooses accounting as a major or simply studies accounting as a general business curriculum requirement, it is important to overall success in business. Dr. Brightman does not use hooks chapter-by-chapter but rather for "modules" of material. His position on this has strongly influenced the way I have organized the book into five parts.

Also see:

www.themasterteacherprogram.com

Brightman, H. "Mentoring Faculty to Improve Teaching and Learning". Decision Sciences Journal of Innovative Education. Vol. 3(2), p.191-204, 2005.

Chapter Lecture

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www.wileyeurope.com/college/monger

This chapter may take considerable time to work through but it pays off later by establishing basic concepts. I use PowerPoint to work through the concepts slowly. Although the text does not introduce an actual set of financial statements until Chapter 3, I think it is useful for students to look at them. In the web site, the financial statements for Emirates Airline are included and I would ask the students on the first day of class to download the most recent year and look it over. At least they have an idea what actual financial statements are like rather than talking about them in the abstract.

Learning Outcome 1

Learning Outcome 1 introduces external users including investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. I ask students at this point two questions:

1. Do you agree that a business has an obligation to all these external users? Or do you believe a business has an obligation only to its owners?

If students say that they have an obligation to all external users, as some will, then I ask:

2. If the interests of different users is in conflict, how do you determine which is the most important?

Learning Outcome 2

The pivotal concept in Learning Outcome 2 is the owner or owners of a business as a separate entity from the business itself. It is relatively easy for a student to see that a customer or supplier is a separate entity, but easy to confuse with the owner. Sometimes I use this example:

A business has one owner. The business owns a truck which it no longer has a use for. The owner decides to take the truck and use it on his weekend farm. I then ask the students: Has a transaction taken place here or not?

Learning Outcome 3

This is where the four financial statements are introduced. In this textbook, the formal names of the statements based on IFRS are used – statement of comprehensive income, statement of financial position, statement of changes in equity and statement of cash flows. The emphasis on the formal names was to make the terminology consistent but also to reinforce the concept of comprehensive income which requires a somewhat different mindset than when the focus is only on profit or loss.

However, once I have introduced the four statements, I then narrow the discussion to the statement of comprehensive income and statement of financial position. Thus, I spend far more time on these two statements. I tell the students that the statement of comprehensive income is the 'recycle bin' of accounting. It deals with only financial information of the past. Nothing on the statement of comprehensive income relates to the future.

I then tell them that all items on the statement of financial position must have future use to the business. Assets will be used by the business in the future; liabilities must be settled by the business in the future. In later chapters when I am working with students on whether to capitalize or expense an item, for example, I come back to this perspective and ask – Does the item have any future relevance to the business?

At this point, I also like to stop and work some of the back-of-chapter application exercises with the students to make sure they have practice in class putting the statements together correctly – especially the statement of comprehensive income and statement of financial position.

Learning Outcome 4

On the accounting process, I have used a synthesized version of the steps in accounting. Automated systems have rendered the trial balance less important. It is these days simply one of the various reports that can be demanded of the system. But also I wanted to focus the student on the major steps – recording transactions, adjusting the ledger accounts, preparing the financial statements and closing temporary accounts. In Chapter 1, I only introduce these steps saying that Part II covers the accounting process in detail.

Learning Outcome 5

I also do not spend much time on generally accepted accounting principles and accounting standards other than to draw the distinction between the accounting process and accounting standards. I tell students that we will examine accounting standards at a basic level in Parts III and IV.

Learning Outcome 6

Again, I touch on the issues in this learning outcome only to illustrate the place they have in the Financial Accounting Reporting System, but defer more discussion until later chapters.

Answers to Learning Outcomes Questions

Learning Outcome 1

Describe the financial information needs of internal and external users.

On Your Own

1. Who are internal users and what uses do they make of accounting information?

Internal users include managers, other employees and members of the board of directors. They use managerial accounting information for planning, decision-making and control. This information is typically not made available to external users.

2. List the types of external users and describe the information requirements of each.

Investors – Those who provide risk capital and their advisors. Their primary needs are for information to help them decide whether to buy, hold or sell equity securities in the company, and whether the company can pay dividends.

Employees – Employees and their representative groups who need information about the stability and the profitability of the business. Employees need financial information to be able to assess the company's ability to provide employment opportunities, and to pay compensation and retirement benefits.

Lenders – The major concern of lenders is whether their loans and the associated interest will be paid when due. Financial information is needed to understand whether the business entity can pay its debts, and if not, what assets are available to secure debts.

Suppliers and other trade creditors – Suppliers and other trade creditors, like lenders, are interested in whether amounts they are owed by the company will be paid.

Customers – Customers, especially those which are dependent on the business, are interested in the long-term viability of the entity.

Governments and their agencies – Governments and agencies need information for regulatory purposes, taxation and to develop national income and other statistics.

Public – The public needs financial information for a variety of purposes such as understanding the contributions to the local economy.

3. For what does financial accounting account?

Financial accounting accounts for financial information only which is the monetary unit concept. Non-financial information is typically not included.

4. What uses do external users make of accounting information?

External users use financial accounting information to evaluate the financial position, performance and changes in financial position of the business entity.

5. Why are internal users more interested in future-oriented information?

This answer to this question is not directly addressed but is implied by the information presented. Internal users – which include managers, other employees and members of the board – are all involved in planning and decision-making that will affect future financial results. While internal users rely on financial information about the past to understand how the business has performed, they also need to make predictions about future financial performance. Examples include the amount of sales in upcoming years or the price that the business can charge its customers.

6. Why is future-oriented financial estimates typically not provided to external users?

Future-oriented financial estimates may reveal plans that management does not want the public to know. For example, management may plan to lower the price of a certain product in the coming year. If this were reported in financial accounting results, then it could alert competitors to the future plans of the business and therefore create a competitive disadvantage.

Learning Outcome 2

Define a business entity and describe the three major forms of business organization.

On Your Own

1. Give examples of the types of entities that typically engage in transactions with a business entity.
Entities which typically engage in transactions include customers, suppliers, employees, investors and creditors.
2. In a previous example, Didier Bihayintore, a sole proprietor, uses the trade name Didier's Restaurant. Are Didier Bihayintore and Didier's Restaurant the same business entity or separate business entities?

Legally Didier Bihayintore and Didier's Restaurant are one in the same since the business is organized as a sole proprietorship. However, we would normally account for the owner and the business as separate entities. Thus, in this example, one set of accounting records would be maintained for Didier Bihayintore and another set for Didier's Restaurant.

3. What is the difference between a business transaction, a financial transaction and a barter transaction?

A business transaction refers to any exchange of value between a business entity and another entity such as a customer, supplier, creditor or employee. A financial transaction is a business transaction that is financial such as borrowing money. A barter transaction is a business transaction that does not involve money.

4. What are the three forms of business organization? What are the advantages and disadvantages of each form?

Limited liability company – Advantages include the ability of the business to engage in transactions including borrowing money in its own name rather than the name of the owners. A limited liability continues operating without disruption when ownership changes which makes raising capital easier. Owners of limited liability companies – the shareholders – have limited liability and while they can lose what they have invested in the business, they are usually not responsible to pay the debts of the limited liability company. The major disadvantage of limited liability companies is that they are more expensive to create and operate.

Sole proprietorship – The major advantages of sole proprietorships is that they are simple and inexpensive to create and operate. One disadvantages of the sole proprietorship form of business organization is that it is more difficult to raise capital. Also the sole proprietor is personally responsible for the repayment of any business debts.

Partnerships – The advantage of partnership is that it allows more than one person to combine their talents and resources in business. The disadvantages are that creditors may seek repayment of business debts from the partners personally. Also partnerships must be dissolved each time a partner leaves the business.

5. What is the difference between a privately held and a publicly traded company? What forms of business organization can each take?

A privately held company is not publicly traded while the shares of a publicly traded company are bought and sold on stock exchanges. Thus shares of publicly traded companies can be bought and sold by the public.

Publicly traded companies are always organized as limited liability companies. A privately held company can be organized as a limited liability company, sole proprietorship or partnership.

Ownership changes to privately held limited liability companies occur when the shares of the business are bought and sold.

Learning Outcome 3

Describe how financial information is reported to external users.

On Your Own

1. What are the elements of each financial statement? Define each of these.

Statement of financial position

- *Assets – What a business owns which are resources the business can use in the future.*
- *Liabilities – What a business owes which are obligations that must be settled in the future.*
- *Equity – The difference between assets and liabilities.*

Statement of comprehensive income

- *Revenue – The flow of economic benefits during the period arising from the entity's business activities.*
- *Expenses – The outflow of economic benefits during the period arising from the entity's business activities.*
- *Profit or loss – Revenue less expenses. If revenue exceed expenses, a profit results. If expenses exceed revenue, a loss results.*
- *Other comprehensive income – Certain income and expenses which are not included in profit or loss.*

Statement of changes in equity

- *Changes to contributed capital – Contributed capital is increased when owners invest additional capital in to the business and it is decreased when owners withdraw their capital from the business.*
- *Changes to retained earnings – Retained earnings is changed by the amount of profit or loss reported on the statement of comprehensive income and decreased by the amount of dividends paid to owners.*
- *Changes to reserves – Reserves are changed by the amount of other comprehensive income reported on the statement of comprehensive income.*

Statement of cash flows

- *Operating activities are cash flows related to the principal revenue-producing activities of the entity that do not qualify as investing or financing activities.*
- *Investing activities are cash flows that relate to the acquisition or disposal of major assets.*
- *Financing activities are cash flows that result in changes in the size and composition of the amount that owners have invested in the business and borrowings.*

Each type of activity – operating, investing and financing – can be both a source and use of cash.

2. What purposes do the notes to the financial statements serve?
Notes provide information that is not included in the four financial statements, or they expand on information presented on the 'face' of the four financial statements. A note can relate to any one, or more than one, of the financial statements.
3. When we say that accounting generates 'general-purpose' financial statements, what are we assuming about the users?
We assume that we are generating financial statements for a broad range of users. Some users may have a sophisticated understanding of business and be able to read and interpret accounting information while others may be less knowledgeable. However, all users are assumed to have a general understanding of business and accounting.
4. What is financial position? What is performance?
Financial position is the relationship of the assets, liabilities and equity of an entity as reported in the statement of financial position. Performance is the relationship of income and expenses of an entity as reported in the statement of comprehensive income.
5. Which financial statements report financial position? Which financial statement report changes in financial position? Which financial statement report performance?
Financial position is reported by the statement of financial position. Changes in financial position are reported by the statement of comprehensive income, the statement of changes in equity and the statement of cash flows. Performance is reported by the statement of comprehensive income.
6. What is the accounting equation?
Assets = Liabilities + Equity
7. What is a line item?
A line item is the most detailed level of information included in a financial statement.
8. What is the difference between profit or loss and other comprehensive income?
Profit or loss includes revenue and expenses that arise from the entity's business activities. Other comprehensive income includes income and expenses that are specifically excluded from profit or loss.
9. What are the different ways to indicate that an amount on the financial statement is negative?
Accountants use many different ways to indicate that an amount is negative. A negative amount could be bracketed. Sometimes a financial statement will indicate that the amount should be subtracted or the financial statement will assume that the user knows that it is negative. For

example, it assumes that the user knows that expenses are always subtracted from revenue. Sometimes negative amounts are shown in red if color is used in the financial statements.

Learning Outcome Practice

1. Trade accounts payable is reported as which of the following?
 - a. A liability on the statement of financial position
2. Equity would appear on which financial statement(s)?
 - d. The statement of financial position and the statement of changes in equity
3. Expenses would appear on which financial statement(s)?
 - a. The statement of comprehensive income only
4. If assets are \$55 000 and equity is \$25 000, how much are liabilities?
 - b. \$30 000
5. Dividends appear on which financial statement(s)?
 - d. The statement of changes in equity only

Learning Outcome 4

Explain the accounting process.

On Your Own

1. What is the major advantage of the double-entry method of accounting?

The double-entry method allows financial information to be summarized and reported in a meaningful way while allowing this information to be related back to the original transactions.
2. What are the four steps in the accounting process?
 - 1) *Analyze and record transactions*
 - 2) *Adjust accounts*
 - 3) *Prepare the financial statements*
 - 4) *Close accounts*

Learning Outcome 5

Define generally accepted accounting principles and explain their role in financial accounting.

On Your Own

1. What are the four major decisions that have to be made when accounting for transactions?
 - 1) *Recognition which relates to whether a transaction should be included?*
 - 2) *Measurement which relates to what amount should be used to measure a transaction?*
 - 3) *Reporting which relates to how financial results should be reported in the financial statements*
 - 4) *Disclosure which relates to what additional information should be provided in the notes.*

2. What are generally accepted accounting principles?
Generally accepted accounting principles (GAAP) include laws, regulations, rules and commonly accepted practices that provide guidance to accounting. GAAP is influenced by academic research as well as the opinions of industry groups, companies and those who prepare financial statements.
3. How do accounting standards and generally accepted accounting principles differ?
Accounting standards are one component of generally accepted accounting principles. Accounting standards are formal, written rules created by governments, quasi-governmental organizations or professional organizations. Accounting standards are specific to nations or regions. Accounting standards are often included as part of a nation's laws.
4. What is the International Accounting Standards Board?
The International Accounting Standards Board (IASB) is an international accounting standards setting organization.
5. What are International Financial Reporting Standards?
International Financial Reporting Standards or IFRS are international accounting standards created by the International Accounting Standards Board (IASB). Some nations have adopted IFRS as their national standards while some other nations have "harmonized" their national standards to be more similar to IFRS.

Learning Outcome 6

Describe the assurance system in financial reporting.

On Your Own

1. How do external users know that financial statements provide a true and fair view of the financial results of the business?
Assurance systems provide users with assurances that the financial statements have been prepared in accordance with applicable generally accepted accounting principles and also present a true and fair view of the financial results of the business. Assurance systems include independent audits by professional accountants.
2. What is an independent audit? Who conducts an independent audit?
An independent audit is a review by an independent professional accountant to ensure that the financial statement have been prepared in accordance with applicable generally accepted accounting principles and present a true and fair view of the financial results of the business. Independent audits are usually but not always conducted by a public accountant with professional credentials like the Certified Public Accountant or Chartered Accountant certificate.

3. Who has the overall responsibility for overseeing financial reporting?

The board of directors in a limited liability company has oversight responsibility for all financial accounting reporting matters. Typically, the board of directors hires the independent auditors and approves the financial statements for release to external users.

4. Who is responsible for preparing the financial statements?

Management is responsible for preparing the financial statements under the oversight of the board of directors.

Answers to Review Questions

1. Who are the external users of financial reports? What are the information requirements of each? How do the needs of external users differ from those of internal users?

External users include the following:

Investors – Those who provide risk capital and their advisors. Their primary needs are for information to help them decide whether to buy, hold or sell equity securities in the company, and whether the company can pay dividends.

Employees – Employees and their representative groups who need information about the stability and the profitability of the business. Employees need financial information to be able to assess the company's ability to provide employment opportunities, and to pay compensation and retirement benefits.

Lenders – The major concern of lenders is whether their loans and the associated interest will be paid when due. Financial information is needed to understand whether the business entity can pay its debts, and if not, what assets are available to secure debts.

Suppliers and other trade creditors – Suppliers and other trade creditors, like lenders, are interested in whether amounts they are owed by the company will be paid.

Customers – Customers, especially those which are dependent on the business, are interested in the long-term viability of the entity.

Governments and their agencies – Governments and agencies need information for regulatory purposes, taxation and to develop national income and other statistics.

Public – The public needs financial information for a variety of purposes such as understanding the contributions to the local economy.

External users need information about the financial results of the business entity that allow them to assess financial position, performance and changes in financial position. These assessments allow them to make decisions about whether to invest in the business entity. It also permits them to determine whether to continue with the existing management or replace it.

Internal users need information for planning, decision-making and control. This information is often future-oriented and therefore must rely on estimates about the future.

2. Describe the three forms of business organization. What are the advantages and disadvantages of each?

Limited liability company – Advantages include the ability of the business to engage in transactions including borrowing money in its own name rather than the name of the owners. A limited liability continues operating without disruption when ownership changes which makes raising capital easier. Owners of limited liability companies – the shareholders – have limited liability and while they can lose what they have invested in the business, they are usually not responsible to pay the debts of the limited liability company. The major disadvantage of limited liability companies is that they are more expensive to create and operate.

Sole proprietorship – The major advantages of sole proprietorships is that they are simple and inexpensive to create and operate. One disadvantages of the sole proprietorship form of business organization is that it is more difficult to raise capital. Also the sole proprietor is personally responsible for the repayment of any business debts.

Partnerships – The advantage of partnership is that it allows more than one person to combine their talents and resources in business. The disadvantages are that creditors may seek repayment of business debts from the partners personally. Also partnerships must be dissolved each time a partner leaves the business.

3. What must a complete set of financial statements include? What question is answered by each financial statement? List and define the major elements in each financial statement. Give examples of specific line items included within each element of the statement of financial position and the statement of comprehensive income. [Example: Trade accounts receivable is an asset on the statement of financial position.]

A complete set of financial statements includes:

- *statement of financial position,*
- *statement of comprehensive income,*
- *statement of changes in financial position,*
- *statement of cash flows, and*
- *notes to the financial statements.*

The questions answered by each financial statement are the following:

Question	Statement
<i>What is the financial position of the business?</i>	<i>Statement of financial position</i>
<i>How did the business perform?</i>	<i>Statement of comprehensive income</i>
<i>What resources have the owners invested in the business?</i>	<i>Statement of changes in equity</i>
<i>Where did the business obtain cash and how was it</i>	<i>Statement of cash flows</i>

used?	
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Major elements of financial statements include:

Statement of financial position

- *Assets – What a business owns which are resources the business can use in the future.*
- *Liabilities – What a business owes which are obligations that must be settled in the future.*
- *Equity – The difference between assets and liabilities.*

Statement of comprehensive income

- *Revenue – The flow of economic benefits during the period arising from the entity's business activities.*
- *Expenses – The outflow of economic benefits during the period arising from the entity's business activities.*
- *Profit or loss – Revenue less expenses. If revenue exceed expenses, a profit results. If expenses exceed revenue, a loss results.*
- *Other comprehensive income – Certain income and expenses which are not included in profit or loss.*

Statement of changes in equity

- *Changes to contributed capital – Contributed capital is increased when owners invest additional capital in to the business and it is decreased when owners withdraw their capital from the business.*
- *Changes to retained earnings – Retained earnings is changed by the amount of profit or loss reported on the statement of comprehensive income and decreased by the amount of dividends paid to owners.*
- *Changes to reserves – Reserves are changed by the amount of other comprehensive income reported on the statement of comprehensive income.*

Statement of cash flows

- *Operating activities are cash flows related to the principal revenue-producing activities of the entity that do not qualify as investing or financing activities.*
- *Investing activities are cash flows that relate to the acquisition of disposal of major assets.*
- *Financing activities are cash flows that result in changes in the size and composition of the amount that owners have invested in the business and borrowings.*

Examples of line items by element for the statement of financial position include:

Element	Line item examples
Assets	<i>Cash in bank</i>
	<i>Trade accounts receivable</i>
	<i>Inventories</i>
	<i>Equipment</i>
	<i>Land</i>
Liabilities	<i>Trade accounts payable</i>
	<i>Wages payable</i>
	<i>Loan payable</i>
Equity	<i>Contributed capital</i>
	<i>Retained earnings</i>
	<i>Reserves</i>

Examples of line items by element for the statement of comprehensive income include:

Element	Line item examples
Revenue	<i>Sales revenue</i>
	<i>Service revenue</i>
Expenses	<i>Cost of goods sold</i>
	<i>Wages expense</i>
	<i>Rent expense</i>
Other comprehensive income	<i>Revaluation reserve</i>

4. What is the accounting process and what was its origin? Give a basic explanation of how the accounting process works.

The accounting process is based on the double-entry method. The double-entry method was created in the 15th century by an Italian mathematician and is used throughout the world today as the basis for accounting activity in both large and small businesses. Business transactions are analyzed and recorded, adjusted and summarized. The accounting process also generates the financial statements.

5. What are generally accepted accounting principles? Describe the difference between generally accepted accounting principles and accounting standards. How are generally accepted accounting principles used in financial accounting? What are International Financial Reporting Standards? *Generally accepted accounting principles (GAAP) include laws, regulations, rules and commonly accepted practices that provide guidance to accounting. GAAP is influenced by academic research as well as the opinions of industry groups, companies and those who prepare financial statements.*

Accounting standards are one component of generally accepted accounting principles. Accounting standards are formal, written rules created by governments, quasi-governmental organizations or professional organizations. Accounting standards are specific to nations or regions. Accounting standards are often included as part of a nation's laws.

Generally accepted accounting principles give guidance to those who prepare financial statements about how to handle specific transactions including on questions of recognition, measurement, reporting and disclosure. Independent auditors use generally accepted accounting principles to determine whether the business entity is in compliance and has presented a true and fair view of financial results.

International Financial Reporting Standards or IFRS are international accounting standards created by the International Accounting Standards Board (IASB). Some nations have adopted IFRS as their national standards while some other nations have “harmonized” their national standards to be more similar to IFRS.

6. Who is ultimately responsible for the financial statements? Who is responsible for preparing financial statements?

The board of directors has the ultimate responsibility for the information reported in the financial statements of the business entity. Management is responsible for preparing the financial statements.

7. What is the assurance system? Describe the major parties that are involved in the assurance system and the role of each. What is the evidence that an external user can rely on the financial statements?

Assurance systems provide users with assurances that the financial statements have been prepared in accordance with applicable generally accepted accounting principles and also present a true and fair view of the financial results of the business.

The board of directors has oversight responsibility for information reported in the financial statements. Management is responsible for preparing the financial statements. And independent auditors review financial statements to give a professional opinion about whether they conform to applicable GAAP and present a true and fair view of the financial results. External users rely on this opinion.

8. Explain why professional ethics must be part of the financial accounting reporting system in order for it to function properly.

Accounting standards cannot address every conceivable transaction and thus some room always exists for judgment. Nor can businesses always prevent fraud and misrepresentation in financial information. Therefore, professional ethics help ensure that reporting is truthful and the results reliable so that a true and fair view of financial results is presented.

Answers to Terminology Practice

1. The **time period assumption** is the division of time into specific time intervals such as a year, quarter or month.
2. When expenses exceed revenue, the business reports a **loss** which is shown on the **statement of comprehensive income**.
3. **Revenue** is the inflow of economic benefits from the ordinary activities of the business entity and is included in the **statement of comprehensive income**.
4. Evidence of ownership of a limited liability company takes the form of **shares**, also known as **stock**, **common shares** or **ordinary shares**.
5. **Liabilities** are what a business owes and are expected to be settled in the future.
6. Sources and uses of cash are known as **cash flows**.
7. Goods held for resale are **inventories** and are included as **assets** on the **statement of financial position**.
8. **Trade accounts payable** are obligations to suppliers that are included on the **statement of financial position**.
9. Formal, written guidelines for accounting developed at the national level are **accounting standards**.
10. The **monetary unit assumption** refers to the fact that we account for information that can be expressed in terms of money.
11. The accounting process uses the **double-entry method**, which accounts for **transactions** between the business entity and other entities.
12. **Notes** accompany the financial statements and either explain information contained in the financial statements or provide additional information.
13. When a company's shares are not publicly traded, the company is **closely held** or **privately held**.
14. Financial accounting provides information for **external users**. Managerial accounting provides information for **internal users**.
15. When revenues exceed expenses, the business reports a **Profit**, which shown on the **statement of comprehensive income**.
16. **Trade accounts receivable** are obligations that customers have to the business, which are included in **assets** on the **statement of financial position**.
17. **Assets** are what a business owns and are expected to have economic benefits in the future.
18. The three forms of business organization are **Limited liability company**, **sole proprietorship** and partnership.
19. Equity shares are traded on the **bourse**, **equity securities market** or **stock market**.
20. **Expenses** are an outflow of economic benefits from ordinary activities of the business entity and are included in the **statement of comprehensive income**.
21. The **reporting date** is the date of the statement of financial position and a **reporting period** is the time in between.
22. The **accounting equation** is $\text{assets} = \text{liabilities} + \text{equity}$. The **income equation** is $\text{revenues} - \text{expenses} = \text{profit or loss}$.

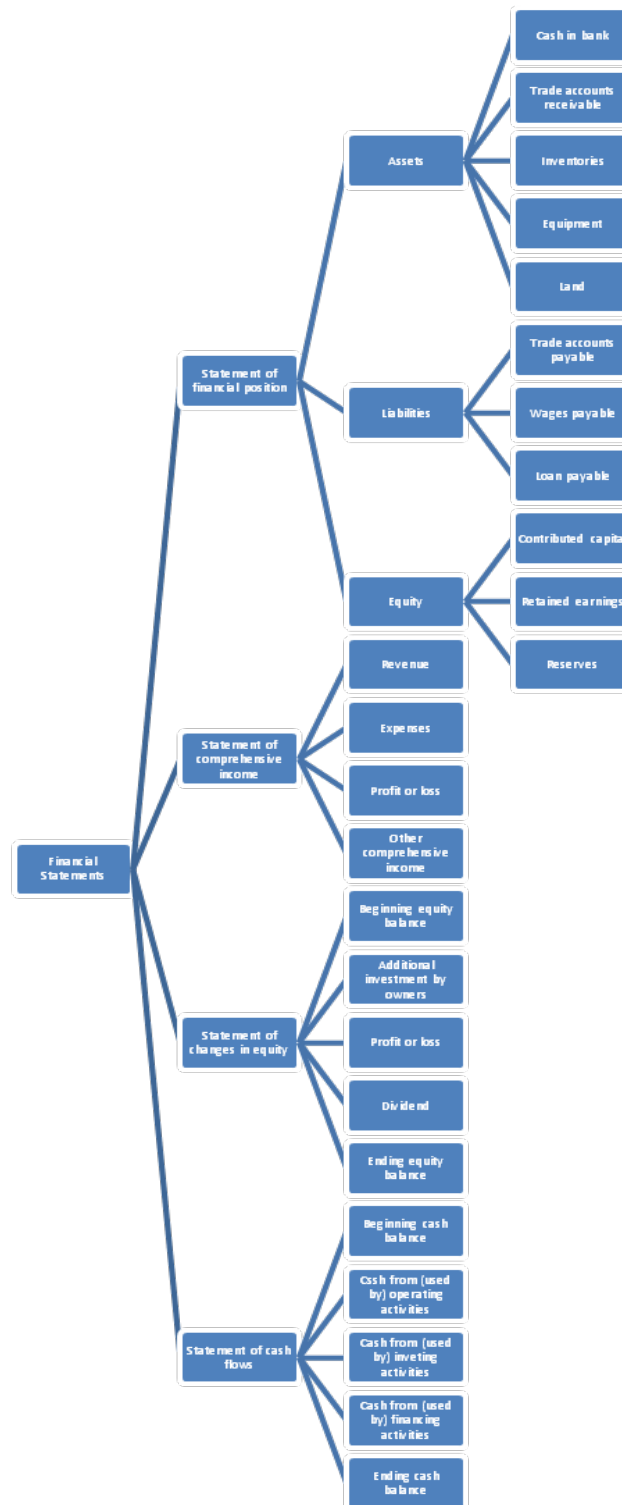
23. Three categories of cash sources and uses are [operating activities](#), [investing activities](#) and [financing activities](#).
24. Profit and loss and other comprehensive income are added to calculate [total comprehensive income](#).
25. When the expenses are subtracted from revenues, the result is [profit or loss](#).

Answers to Application Exercises

- Place a tick in the appropriate boxes to indicate which financial statements the items in the left-hand column apply to.

	Statement of comprehensive income	Statement of financial position	Statement of changes in equity	Statement of cash flows
Assets		✓		
Cash from investing activities				✓
Contributed capital including changes		✓	✓	✓
Trade accounts payable		✓		
Retain earnings		✓	✓	
Revenue	✓			
Cash from financing activities				✓
Expenses	✓			
Trade accounts receivable		✓		
Liabilities		✓		
Wages payable		✓		
Cash from operating activities				✓
Profit or loss	✓		✓	
Beginning equity balance			✓	
Loan payable		✓		
Ending equity balance		✓	✓	
Inventories		✓		
Cash in bank		✓		✓

2. Complete the items in the following diagram by writing in the appropriate name of the financial statement, financial statement element or line item.



3. Complete the following schedule by supplying the missing information for each of the three companies:

Company A	Expenses	£105 000
	Assets	£1 250 000
Company B	Profit (loss)	(£25 000)
	Equity	£200 000
Company C	Revenue	£812 000
	Liabilities	£2 400 000

4. Complete the following schedule by supplying the missing information for each of the three companies.

Company A	Equity (2010)	\$1000
	Liabilities	\$13 500
	Profit (loss)	\$1 500
Company B	Liabilities	\$15 000
	Equity (2010)	\$14 700
	Assets	\$28 000
	Revenue	\$2 000
Company C	Equity (2010)	\$433 000
	Equity (2011)	\$440 000
	Revenue	\$350 000
	Profit (loss)	\$230 000

5. Complete the following schedule by supplying the missing information for each of the four companies:

Company A	Dividends	€50
Company B	Ending equity balance	€745
Company C	Sale of ordinary shares	€200
Company D	Profit (loss)	€25

6. Complete the following schedule by supplying the missing information:

Company A	Cash from (used by) investing activities	(€3000)
	Ending cash balance	€12 500
Company B	Cash from (used by) operating activities	(€12 000)
	Net change in cash balance	(€12 500)
Company C	Cash from (used by) financing activities	(€225 000)
	Beginning cash balance	€1 200 000

7. Based on the information below for Maize Industries LLC, construct a statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows for the year ended 31 December 2010. Use appropriate headings for each statement.

Maize Industries, LLC Statement of Financial Position 31 December 2010 – Euros €			
Assets		Liabilities	11 250 000
Cash in bank	6 310 000	Equity	<u>1 350 000</u>
Other assets	<u>6 290 000</u>		
TOTAL ASSETS	1 2600 000	TOTAL LIABILITIES AND EQUITY	12 600 000

Maize Industries, LLC Statement of Comprehensive Income For the year ended 31 December 2010 – Euros €	
Revenue	3 750 000
Expenses	<u>2 800 000</u>
Profit	950 000
Other comprehensive income	<u>0</u>
Total comprehensive income	950 000

Maize Industries, LLC Statement of Changes in Equity For the year ended 31 December 2010 – Euros €	
Beginning balance, 1 January 2010	700 000
Ordinary shares sold	200 000
Profit	950 000
Dividend	<u>(500 000)</u>
Ending balance, 31 December 2010	1 350 000

Maize Industries, LLC Statement of Cash Flows For the year ended 31 December 2010 – Euros €	
Net cash from operating activities	8 400 000
Net cash used by investing activities	(4 790 000)
Net cash from financing activities	<u>2 000 000</u>
Net increase in cash	5 610 000
Cash balance, 1 January 2010	<u>700 000</u>
Cash balance, 31 December 2010	6 310 000

Case Analysis

To the Instructor

This case asks students to examine three years of financial statements about Italian Naturals, SpA, a start-up company which manufactures soaps. It is, of course, too early for students to perform a meaningful analysis. Instead the purpose of this case is three fold: 1) to give students practice reading and becoming familiar with financial statements, 2) practice thinking about what financial statements are reporting, and 3) practice thinking about differences between financial statement elements (e.g., that in 2011 the company had a €2000 profit but at the same time reported a use of cash by operating activities of €2000).

First question set:

We will learn about some techniques later in the textbook to analyze the financial statements but at this point we can make a few observations.

1. What is the financial position of the business?

To answer this question, we would examine the statement of financial position. We can make two observations about assets. First over the three year period, the amounts for trade accounts receivable, inventories and supplies increase with the biggest change coming between 2009 and 2010. Second we can see that in 2011, the company purchased €50 000 in equipment which appears in assets for the first time.

Liabilities also increase. The biggest change comes in 2011 when the €50 000 loan payable appears. This is the money Paolo's parents have lent the company.

In the equity section, we can see that 2009 shows the share capital of €20 000 that Paolo initially invested to begin the business. This increases to €40 000 in 2010 because Matt Hopes invested a like amount. The amount of share capital does not change between 2010 and 2011. We can also see that the total amount of equity is only €13 500 for 2009, less than the amount Paolo invested because the Italian Naturals had a loss that resulted in a negative retained earnings balance. In 2010, the company had another loss for €5000 which caused the negative retained earnings balance to increase to €11 500. This resulted in total equity of €28 500 which is less than the total amount Paolo and Matt have invested of €40 000. In 2011, the Italian Naturals reports its first profit of €2 000. This increases retained earnings but the balance is still negative €9 500 [=(11 500) + 2 000].

2. How did the business perform?

Performance is reported by the Statement of Comprehensive Income. As noted above, the business reported a loss for 2009 and 2010. It reported its first profit in 2011.

3. What resources have the owners invested in the business?

This question is answered by the Statement of Changes in Equity. We can see that the owners invested a total of €40 000 -- €20 000 by Paolo in 2009 and €0 000 by Matt in 2010. No additional investment was made in 2011. However, since the company has losses that exceed profits over the three years, the amount invested has decreased.

4. Where did the business obtain cash and how was it used?

This question is answered by the Statement of Cash Flows. We can see that operating activities have been a use of cash in all three years though the amount being used is decreasing from €15 000 in 2009 to €21 500 in 2010 to €2 000 in 2011. The only cash flow related to investing activities was in 2011 when the company acquired €50 000 of equipment. Financing activity was the sole source of cash in all three years. In 2009, Paolo's investment was a source for €20 000, in 2010 Matt's investment was a source for €20 000 and in 2011 Paolo's parent loan was a source of cash to the company for €50 000.

Second question set:

1. In 2009, did Paolo do a good job managing the business? What did he do well? What needed improvement? What specific recommendations would you have for Paolo related to the business in 2009?

It's impossible to answer this question definitively. Clearly, starting a new business is time consuming and it's typical for entrepreneurs like Paolo to spend a lot of time learning the business. To his credit, Paolo did add a few new customers. It is not unusual for a business to report a loss in its first years of operations so that too is not a cause for much concern in 2009. But also the business used up the majority of its cash in the first year and this is a concern especially since trade accounts receivable, inventories and supplies are all large numbers.

Could Paolo have done a better job collecting amounts owed to the business by his customers? Did he really need to have such a large inventory and purchase so many supplies at this point? But these are questions worth asking? Maybe Paolo would have been better off if he had a business partner from the start that focused on financial issues and sales or perhaps he could have hired someone to manage this.

2. In 2010, did Paolo and Matt do a good job managing the business? What did they do well? What needed improvement? Again, what specific recommendations would you have for Paolo and Matt related to the business in 2010?

Paolo and Matt were able to increase the amount of sales revenue as shown on the Statement of Comprehensive Income. Expenses also increased only slightly over 2009 expenses which resulted in

a smaller loss than what had been reported in 2009. However, what is worrisome is the big increase in the trade accounts receivable, inventories and supplies balances on the statement of financial position. The other concern is the large amount of cash that was used by operating activities. Paolo and Matt should make an effort to control these balances and also pay close attention to the amount of cash they will need. Most new businesses fail because they run out of cash!

3. In 2011, did Paolo and Matt do a good job managing the business? What did they do well? What needed improvement? Again, what specific recommendations would you have for Paolo and Matt related to the business in 2011?

2011 is a significant improvement over the previous two years. Sales revenue has increased significantly and for the first time the company has reported a profit. On the statement of financial position, there is more reason to be hopeful because trade accounts receivable, inventories and supplies balances have increased only by a small amount over 2010. Also, on the statement of cash flows, cash used by operating activities has decreased significantly.

Though it's still too early to tell, the company appears to be headed in the right direction. The interesting questions for 2012 will be whether the business reports an increase in profit and also whether operating activities becomes a source of cash.

Additional Case

Aussie Pies (A)

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There are four cases in the Aussie Pie series (A, B, C and D). Others are included in later chapters. Aussie Pies (A) is a brief case that asks the students to consider what the monthly cost would be to run a new business that makes Aussie-style meat pies. The student is given the selling price and a list of costs. Some are variable and some are fixed which of course is appropriate to managerial accounting. However, the student does not need to understand cost behavior in order to complete the case.

Suggested case questions:

Financial information is presented for only one month.

1. What would the statement of comprehensive income be for this company assuming that it sold 30,000 meat pies each month? Would the business make a profit or loss?
2. What would the statement of financial position be for this company assuming that it sold 30,000 meat pies each month?

Given the facts in the case, all items belong on the statement of comprehensive income. These should appear as shown below:

Statement of Comprehensive Income		
Revenue	30 000 x \$3.25	\$97 500
Less: Expenses		
Ingredients	30 000 x \$1.20	36 000
Store rent		11 900
Cooking equipment rental		8 000
Fixture rental		5 000
Chefs	2 chefs x \$1800	3 600
Sales assistant		1 200
Utilities per pie	30 000 x \$0.03	900
Pie boxes	30 000 x \$0.02	600
Utilities costs for lighting the store		300
Total expenses		67 500
Profit		\$30 000
Other comprehensive income		0
Total comprehensive income		\$30 000

The business made a profit of \$30 000.

A statement of financial position cannot be prepared because the case provides no evidence of assets, liabilities or equity.