Chapter 1

Accounting and the Business Environment

Chapter 1: Overview

The chapter begins with an introduction to accounting and a brief discussion of why accounting is important. The differences between financial and managerial accounting are delineated. The text discusses how accounting information is needed by various users—individuals, businesses, investors, creditors, and taxing authorities. Reasons accounting is important to students not majoring in accounting and career paths available to accounting majors are briefly described, including a comparison of various accounting positions. The role of governing organizations such as the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) as well as the FASB’s relationships with both congressionally created and private accounting groups are explained. Generally Accepted Accounting Principles (GAAP) are introduced. The sole proprietorship, partnership, corporation, and limited liability company (LLC) forms of business are briefly described in the context of the economic entity assumption. In addition, the cost principle, going concern assumption, and monetary unit assumption are explained. The nature of International Financial Reporting Standards (IFRS) and the role of the International Accounting Standards Board (IASB) in their development are explained. The role of ethics in accounting and business is described. The U.S. government’s passing of the Sarbanes-Oxley Act (SOX) and the creation of the Public Company Accounting Oversight Board (PCAOB) are presented.

The next section of the chapter introduces the accounting equation: Assets = Liabilities + Equity. Each element of the accounting equation is defined. Nine basic business transactions are analyzed, and their impact on the accounting equation is discussed. The financial statements—income statement, statement of retained earnings, balance sheet, and statement of cash flows—are illustrated. The interrelationship of the financial statements is emphasized.

A Tying It All Together feature poses four questions regarding a company’s asset, liability, revenue, and expense accounts and the proper financial statement reporting for each. Financial statements and return on assets (ROA) are used to evaluate business performance. A Decisions feature helps students see how financial statements and ROA can be used to make real-world decisions. The Review section includes Things You Should Know which highlights the information students should have acquired from the chapter. A Check Your Understanding feature allows students to record the effects of transactions on the accounting equation, prepare financial statements, and calculate ROA. A list of Key Terms is provided. A Quick Check gives students a chance to assess their knowledge of the chapter learning objectives.

**Chapter 1: Learning Objectives**

1. Explain why accounting is important and list the users of accounting information
2. Describe the organizations and rules that govern accounting
3. Describe the accounting equation and define assets, liabilities, and equity
4. Use the accounting equation to analyze transactions
5. Prepare financial statements
6. Use financial statements and return on assets (ROA) to evaluate business performance

**Chapter 1: Teaching Outline with Lecture Notes**

1. Explain why accounting is important and list the users of accounting information
   1. Define the term accounting and explain what accountants do
   2. Exhibit 1-1: Pathways Vision Model

Lecture Notes: Accounting is defined as the information system that measures business activities, processes the information into reports, and communicates the results to decision makers. However, accountants do not simply prepare various types of accounting reports and tax returns. They also review and interpret business information using critical thinking and judgment to partner with clients and managers to help them make better business decisions.

* 1. Differentiate between financial accounting and managerial accounting
  2. Exhibit 1-2: Decision Making: Financial Versus Managerial Accounting

Lecture Notes: Financial accounting provides historical information—the company reports on events that have already occurred—to external decision makers, including investors and creditors. Managerial accounting provides more future-oriented information—many companies prepare budgets, forecasts, and projections based on future events—for internal decision makers (company managers and executives).

* 1. Identify the users of accounting information:
     1. Individuals
     2. Businesses
     3. Investors
     4. Creditors
     5. Taxing authorities

Lecture Notes: The officers of a company may be (and probably are) stockholders as well. Not all investors are “outside” the company. The financial statements are the primary tools for providing information to outside investors; but officers may also use the statements, along with other financial information, to manage the company on a day-to-day basis.

* 1. Describe career options and certifications available in the accounting profession

Lecture Notes: Not all accountants are licensed, and those who are may not necessarily be members of the AICPA and IMA, the professional associations described in the textbook. There are many other types of accounting-related associations and certifications in the United States and elsewhere around the world, including Certified Internal Auditor (CIA), Certified Government Financial Manager (CGFM), Certified Fraud Examiner (CFE), Certified Financial Manager (CFM), Enrolled Agent (EA), Chartered Global Management Accountant (CGMA), Chartered Accountant (CA), and many more.

* 1. Exhibit 1-3: Comparison of Accounting Positions

Suggested In-Class Exercise: E1-17

1. Describe the organizations and rules that govern accounting
   1. Identify accounting governing organizations, including the Financial Accounting Standards Board (FASB), the Security Exchange Commission (SEC), and the International Accounting Standards Board (IASB)
   2. Describe Generally Accepted Accounting Principles (GAAP) and introduce the primary objective of financial reporting
   3. Explain the economic entity assumption
      1. Identify the different types of business organizations:
         * Sole proprietorship
         * Partnership
         * Corporation
         * Limited-liability company (LLC)
      2. Exhibit 1-4: Business Organizations
      3. Describe the distinguishing characteristics and organization of a corporation:
         * Separate legal entity
         * Continuous life and transferability of ownership
         * No mutual agency
         * Limited liability of stockholders
         * Separation of ownership and management
         * Corporate taxation
         * Government regulation
         * Organization
      4. Exhibit 1-5: Structure of a Corporation

Lecture Notes: Corporate status is not based on the size of the company. Not all large companies are corporations, and not all small companies are sole proprietorships or partnerships. A corporation could have only one stockholder. Why would a one-shareholder business incorporate the business in this case? One reason is limited liability protection. Regardless of the number of stockholders, all corporations follow the same general corporate procedures.

* 1. Explain the cost principle
  2. Explain the going concern assumption

Lecture Note: Point out to students that if it is known that a company should not be considered a going concern, different accounting rules from those covered in this course apply to that company.

* 1. Explain the monetary unit assumption

Lecture Note: Point out to students that an implication of the monetary unit assumption is that business activities that cannot be expressed in monetary units are not represented within the financial statements. For example, a company with a well-trained workforce, talented managers, a good reputation with customers, and innovative research and development has important assets that are not represented on the balance sheet.

* 1. Describe International Financial Reporting Standards (IFRS)
  2. Ethics in accounting and business
     1. Sarbanes-Oxley Act (SOX)
     2. Public Company Accounting Oversight Board (PCAOB)

Lecture Notes: Not all accounting information and financial statements are publicly available; such information is disclosed by public companies only. Company size is not a determinant of public ownership; some large companies are still privately held. All companies, public and private, can follow GAAP. However, this may not be a requirement for private companies. Private companies can use other bases of accounting, such as the cash basis, unless GAAP is required due to an audit. There is also a difference between record keeping and financial statement preparation. Companies can keep their accounting records on another basis and convert the financial statements to GAAP. For example, small private companies may use the cash basis for record keeping and convert to the accrual basis for financial statement preparation.

The Sarbanes-Oxley Act and the PCAOB relate to public companies. As a rule, public companies are more regulated (in terms of accounting information) than private companies. Some companies are now going private; one reason for doing so may be to reduce the compliance cost associated with these additional regulations.

Although much has been written and discussed about the possibility of convergence of U.S. GAAP and IFRS, complete convergence appears to be increasingly unlikely. The SEC previously announced a policy dedicated to investigating endorsement of IFRS, but political winds now seem to be shifting. Furthermore, standard-setting paths of FASB and IASB sometimes converge, as in recent development of unified revenue recognition standards, but sometimes fail to converge, as in recent issuance of very different guidance on leases. For now, U.S. GAAP continue to be different in many respects from IFRS, a condition which seems likely to continue for the foreseeable future, although efforts to increase similarities also continue to meet with some degree of success.

Suggested In-Class Exercise: E1-18

1. Describe the accounting equation and define assets, liabilities, and equity
   1. The accounting equation: Assets = Liabilities + Equity
   2. Define assets
   3. Define liabilities
   4. Define equity

Lecture Notes: The accounting equation must always balance. Demonstrate that the accounting equation always balances, not just at the beginning of the year (or any accounting period). During the year, the change in assets equals the change in liabilities plus the change in equity. At the end of the year, the new values of the accounting equation will balance.

|  |  |  |  |
| --- | --- | --- | --- |
| Beginning of Year | Assets = | Liabilities + | Equity. |
| During the Year | Δ Assets = | Δ Liabilities + | Δ Equity. |
| End of Year | New Assets = | New Liabilities + | New Equity. |

Discuss with students that while most textbook examples show companies that are profitable from the very beginning and always have positive equity balances, stockholders’ equity can be negative if liabilities exceed assets, but the accounting equation would still balance. If a company records net losses in the very beginning, Retained Earnings will be negative, and the company will record Accumulated Deficit instead of Retained Earnings. For example, a company could have $100 of assets, $150 of liabilities, and $(50) of equity, and the accounting equation would equal $100 on each side. While this position is usually not desirable, it is not unusual in the business world, especially for new businesses.

Suggested In-Class Exercise: E1-21

1. Use the accounting equation to analyze transactions
   1. Transaction analysis for Smart Touch Learning
2. Transaction 1—Stockholder contribution
3. Transaction 2—Purchase of land for cash
4. Transaction 3—Purchase of office supplies on account
5. Transaction 4—Earning of service revenue for cash
6. Transaction 5—Earning of service revenue on account
7. Transaction 6—Payment of expenses with cash
8. Transaction 7—Payment on account (Accounts Payable)
9. Transaction 8—Collection on account (Accounts Receivable)
10. Transaction 9—Payment of cash dividend
11. Exhibit 1-6: Analysis of Transactions, Smart Touch Learning

Lecture Notes: Every basic transaction always affects at least two accounts. Becoming familiar with each of the nine basic transactions and the two accounts affected by each will promote development of students’ transaction analysis skills. Demonstrate the following transaction analysis process for each transaction:

1. Identify the accounts and the account type.
2. Decide if each account increases or decreases.
3. Determine if the accounting equation is in balance.

When this process is applied correctly, the accounting equation will always balance. Thus, for all transactions that occur during the year:

|  |  |  |  |
| --- | --- | --- | --- |
| During the Year | Δ Assets = | Δ Liabilities + | Δ Equity |

Note that every transaction affects the balance sheet in some way—increasing or decreasing an asset, liability, or equity account—but may or may not affect another financial statement. Remind students that there are four kinds of equity accounts: contributed capital, revenues, expenses, and dividends. Thus, there are four ways that equity can change during the year:

|  |  |  |  |
| --- | --- | --- | --- |
| During the Year | Δ Assets = | Δ Liabilities . | + Contributed Capital |
| + Revenues |
| – Expenses |
| – Dividends |

Some students may be confused by how the issuance of stock increases a company’s equity. “If the company issues the stock, how is the stock account increasing?” Explain that when a company issues stock, it increases the amount of common stock outstanding (or in the hands of stockholders). This results in an increase in Assets (Cash) and an increase in Common Stock (Equity).

Also, it may be helpful to point out that some transactions affect only one side of the accounting equation (left or right), yet the accounting equation still balances. For example, when a company purchases supplies with cash, one asset increases and another asset decreases—with no effect on liabilities and equity. Thus, the accounting equation balances.

Suggested In-Class Exercise: E1-27

1. Prepare financial statements
   1. Exhibit 1-7: Financial Statements
      1. Exhibit 1-8: Income Statement
      2. Exhibit 1-9: Statement of Retained Earnings
      3. Exhibit 1-10: Balance Sheet
      4. Exhibit 1-11: Statement of Cash Flows

Lecture Notes: Each of the financial statements required by GAAP focuses on a different aspect of the company’s financial position or financial activity. All four statements should be analyzed in order to get a complete picture of a company. Emphasize the links between the statements.

The income statement shows the change in equity that results from the operation of the business during the year. The retained earnings statement shows the change in equity from profits earned less dividends paid to the stockholders during the year. Balance sheets show the financial position of the company at specific points in time. The statement of cash flows shows the change in Cash in relation to everything else that changed during the year.

Each financial statement should have a company name, a statement title, and some form of date. The balance sheet shows the financial composition of the company at a specific point in time, such as at the end of the year. The balance sheet will probably change the day after it is prepared. All the other financial statements describe what happened to the company *during* the year. The income statement tracks profitability—revenues minus expenses. Remember that “profit” doesn’t necessarily mean “money”; the profit may not have been collected in cash yet. The statement of retained earnings shows the changes in the portion of equity arising from the results of operations (but not the changes in contributed capital) less dividends paid to stockholders. As profits increase, stockholders’ equity will increase; as dividends are paid, profits remaining in the business will decrease. The statement of cash flows describes how the balance of the Cash account changed in relation to changes in other assets, liabilities, and all the components of equity.

Financial position (the balance sheet) is different from profitability (the income statement). A company could be very profitable and do a terrible job of managing its profits or vice versa. Students probably know a person who is like this. Some people have high income levels and end up with very little net worth because they do not manage their finances effectively. On the other hand, some people have modest income levels and do a very good job of managing their finances.

The cash flow statement shows how the company is generating and using its cash. Students may have heard the phrase “cash is king”; a company must have cash to pay its outstanding bills. Some recent accounting fraud cases involved companies that reported great profits but no corresponding cash flow—a possible red flag!

Net income and cash flow are separate concepts; neither is always positive. A company could have net income and negative cash flow in one year, and then the company could have a net loss and positive cash flow in another year. Many creditors will focus on cash flow in order to determine whether a company can generate cash in order to pay back any outstanding liabilities.

The stockholders’ equity balance does not represent the balance in the Cash account. Students sometimes think the corporation can simply declare dividends from profits earned at any given time. However, the income included in stockholders’ equity is based on accrual accounting and may not yet have been collected in cash. In addition, some items that have been paid in cash may not be included in net income until some future period.

Suggested In-Class Exercises: E1-31, E1-32, E1-33

1. Use financial statements and return on assets (ROA) to evaluate business performance
   1. Review financial statements of Kohl’s Corporation. (see http://www.pearsonhighered.com/Horngren)
   2. Explain return on assets (ROA)

Lecture Notes: Information presented in the financial statements is largely based on historical cost—the cost principle. Beginning students may think the value of total assets on the balance sheet represents the “true” value of the company, which is incorrect. The balance sheet values of major assets such as land, buildings, and equipment are based on the historical cost of those assets and may not represent their fair market value. For example, land purchased 10 years ago is likely to be worth more than the original cost, but it would still be valued on the balance sheet at original cost. This difference between the fair market value and the balance sheet value is sometimes called “hidden assets.” How are the “true” values of a company’s assets determined? One could have them appraised, but even then, the current fair market value of assets does not represent the value of the company as a whole. Don’t forget about subtracting liabilities! But, of course, even then the resulting value of stockholders’ equity (fair market value of all the assets minus liabilities) does not necessarily represent the true market value of the company as a whole.

Return on assets measures how well a company uses its assets to generate profits. It is calculated by dividing net income by average total assets. Average total assets is calculated by adding the beginning and ending total assets for the time period and then dividing by two.

Suggested In-Class Exercise: E1-27

Chapter 1: Handout for Student Notes

1. Why is accounting important?
   * Decision makers: The users of accounting information
     + Individuals
     + Businesses
     + Investors
     + Creditors
     + Taxing authorities
   * Accounting matters
2. What are the organizations and rules that govern accounting?
   * Governing organizations
   * Generally Accepted Accounting Principles (GAAP)
   * The economic entity assumption
     + Distinguishing characteristics and organization of a corporation
   * The cost principle
   * The going concern assumption
   * The monetary unit assumption
   * International Financial Reporting Standards
   * Ethics in accounting and business
3. What is the accounting equation?
   * Assets
   * Liabilities
   * Equity
4. How do you analyze a transaction?
   * Transaction analysis for Smart Touch Learning
     + Transaction 1—Stockholder contribution
     + Transaction 2—Purchase of land for cash
     + Transaction 3—Purchase of office supplies on account
     + Transaction 4—Earning of service revenue for cash
     + Transaction 5—Earning of service revenue on account
     + Transaction 6—Payment of expenses with cash
     + Transaction 7—Payment on account (Accounts Payable)
     + Transaction 8—Collection on account (Accounts Receivable)
     + Transaction 9—Payment of cash dividend
5. How do you prepare financial statements?
   * Income statement
   * Statement of retained earnings
   * Balance sheet
   * Statement of cash flows
6. How do you use financial statements to evaluate business performance?
   * Kohl’s Corporation (http://www.pearsonhighered.com/Horngren)
   * Return on assets (ROA)

**Chapter 1: Student Chapter Summary**

1. Explain why accounting is important and list the users of accounting information

Accounting is the language of business. Financial accounting is used by a variety of decision makers outside the company, including individuals, businesses, investors, creditors, and taxing authorities, while managerial accounting is directed to decision makers inside the company. All businesses need accountants. Accountants work in public accounting, private accounting, and governmental accounting jobs. They can be licensed as a certified public accountant (CPA) or serve as a certified management accountant (CMA). Further, non-accountant business professionals require accounting knowledge as well, as they regularly utilize accounting information to make business decisions.

1. Describe the organizations and rules that govern accounting

The rules that govern accounting are called Generally Accepted Accounting Principles (GAAP). The Financial Accounting Standards Board (FASB) is responsible for the creation and governance of U.S. GAAP. The Securities and Exchange Commission (SEC) oversees the U.S. financial markets and other standard setters, such as the FASB.

A thorough understanding of GAAP is essential to the use and preparation of financial statements. The primary objective of financial reporting is to provide information useful for making investment and credit decisions. Financial statement information must be relevant and have faithful representation to be considered useful. Relevant information is timely and is capable of making a difference in the user’s decision. Information is faithfully representative when it is complete, neutral, and free from error.

Four accounting principles are introduced. The economic entity assumption requires that the subject of a set of accounting financial statements is a single economic unit separate and distinct from its owners and from other economic units. The cost principle requires that transactions record acquisition of assets and services at their actual cost. The going concern assumption specifies that financial reporting should presume the entity will remain in operation for the foreseeable future. The monetary unit assumption requires that only economic events that can be measured in monetary units are represented in the financial statements.

1. Describe the accounting equation and define assets, liabilities, and equity

The fundamental relationship on which all accounting is based is represented by the accounting equation: Assets = Liabilities + Equity. Assets are economic resources with future benefits. Liabilities are obligations owed to others. Equity represents the residual value of the assets left over after obligations represented by the liabilities are fulfilled.

1. Use the accounting equation to analyze transactions

Transactions are economic events that affect the financial position of the company and can be measured reliably. Basic transactions affect at least two accounts. Transactions are analyzed in three steps:

* 1. Identify the accounts and the account type (Asset, Liability, or Equity).
  2. Decide whether each account increases or decreases.
  3. Determine whether the accounting equation is in balance.

1. Prepare financial statements

Four financial statements are prepared for each accounting period. The income statement reports net income or net loss, calculated as revenues earned minus expenses incurred, for a specific period of time. The statement of retained earnings reports the change in retained earnings from net income (or net loss) minus dividends for a specific period of time. The balance sheet reports the financial position (assets, liabilities, and equity) of the company at a specific point in time. The statement of cash flows reports the cash receipts and cash payments categorized by operating, investing, and financing activities.

1. Use financial statements and return on assets (ROA) to evaluate business performance

The income statement evaluates profitability. The statement of retained earnings shows the amount of earnings kept and reinvested in the company. The balance sheet lists the economic resources owned, the debts and obligations owed, and the residual interest that remains for the stockholders. The statement of cash flows shows the change in cash resulting from operating, investing, and financing activities. Return on assets measures how profitably the company uses its assets.

# Chapter 1: Assignment Grid and Other Materials

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **LO 1** | **LO 2** | **LO 3** | **LO 4** | **LO 5** | **LO 6** |
| S1-1 | X |  |  |  |  |  |
| S1-2 |  | X |  |  |  |  |
| S1-3 |  | X |  |  |  |  |
| S1-4 |  | X |  |  |  |  |
| S1-5 |  | X |  |  |  |  |
| S1-6 |  |  | X |  |  |  |
| S1-7 |  |  | X |  |  |  |
| S1-8 |  |  | X |  |  |  |
| S1-9 |  |  |  | X |  |  |
| S1-10 |  |  |  | X |  |  |
| S1-11 |  |  |  |  | X |  |
| S1-12 |  |  |  |  | X |  |
| S1-13 |  |  |  |  | X |  |
| S1-14 |  |  |  |  | X |  |
| S1-15 |  |  |  |  | X |  |
| S1-16 |  |  |  |  |  | X |
| E1-17 | X |  |  |  |  |  |
| E1-18 |  | X |  |  |  |  |
| E1-19 |  |  | X |  | X |  |
| E1-20 |  |  | X |  |  |  |
| E1-21 |  |  | X |  |  |  |
| E1-22 |  |  | X |  |  |  |
| E1-23 |  |  | X |  |  |  |
| E1-24 |  |  | X |  |  |  |
| E1-25 |  |  |  | X |  |  |
| E1-26 |  |  |  | X |  |  |
| E1-27 |  |  |  | X |  |  |
| E1-28 |  |  |  | X |  |  |
| E1-29 |  |  |  | X |  |  |
| E1-30 |  |  |  |  | X |  |
| E1-31 |  |  |  |  | X |  |
| E1-32 |  |  |  |  | X |  |
| E1-33 |  |  |  |  | X |  |
| E1-34 |  |  |  |  | X |  |
| E1-35 |  |  |  |  | X |  |
| E1-36 |  |  |  |  | X |  |
| E1-37 |  |  |  |  | X |  |
| E1-38 |  |  |  |  | X |  |
| E1-39 |  |  |  |  |  | X |

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **LO 1** | **LO 2** | **LO 3** | **LO 4** | **LO 5** | **LO 6** |
| P 1-40A, P1-47B |  |  |  | X |  |  |
| P 1-41A, P1-48B |  |  |  | X |  |  |
| P 1-42A, P1-49B |  |  |  |  | X |  |
| P 1-43A, P1-50B |  |  |  |  | X |  |
| P 1-44A, P1-51B |  |  |  |  | X |  |
| P 1-45A, P1-52B |  |  |  | X | X |  |
| P 1-46A, P1-53B |  |  |  | X | X |  |

**S – Short Exercises (*Easy)***

**E – Exercises (*Moderate)***

**P – Problems (*Difficult)***

**Other End-of-Chapter Materials:**

|  |
| --- |
| Using Excel Problem P1-54 |
| Continuing Problem P1-55 |
| Tying It All Together Case 1-1 |
| Decision Case 1-1 |
| Ethical Issue 1-1 |
| Fraud Case 1-1 |
| Financial Statement Case 1-1 |

**CHAPTER 1**

**TEN-MINUTE QUIZ**

***Circle the letter of the best response.***

1. Financial markets in the United States are regulated by which of the following organizations?
   1. American Institute of Certified Public Accountants (AICPA)
   2. Financial Accounting Standards Board (FASB)
   3. International Accounting Standards Board (IASB)
   4. Securities and Exchange Commission (SEC)
2. Which type of business organization is a taxable entity, separate and apart from its owners?
3. Proprietorship
4. Partnership
5. Corporation
6. All of the above
7. Which accounting principle or assumption assumes that an entity will remain in operation for the foreseeable future?
8. Economic entity assumption
9. Cost principle
10. Monetary unit assumption
11. Going concern assumption
12. Red Door Boutique is famous for fashion wristwatches and leather purses. At the end of a recent year, Red Door’s total assets added up to $485,000,000, and liabilities were $163,000,000. How much was Red Door’s equity?
13. $163,000,000
14. $322,000,000
15. $485,000,000
16. $648,000,000
17. Assume that Red Door Boutique purchased supplies on account for $58,000. How would this transaction affect Red Door’s accounting equation?
18. Increase assets and liabilities by $58,000
19. Increase assets and equity by $58,000
20. Increase liabilities and equity by $58,000
21. Increase one asset and decrease another asset by $58,000
22. Which field of accounting provides information to external decision makers such as investors and lenders?
23. Investment accounting
24. Tax accounting
25. Managerial accounting
26. Financial accounting
27. Which of the following is a characteristic of a limited-liability company?
28. Indefinite life
29. Separate taxable entity
30. One or more stockholders
31. Personally liability of owner
32. Last year, Internet Service Company (ISC) sold services on account for $75,000 and incurred expenses totaling $48,000. At the end of the year, the balance for Accounts Receivable was $10,000, and the balance for Accounts Payable was $8,000. What was ISC’s net income or net loss for the year?
33. Net income of $29,000
34. Net income of $27,000
35. Net income of $25,000
36. Net income of $9,000
37. The income statement reports the
38. financial position for a specific period.
39. financial position on a specific date.
40. results of operations for a specific period.
41. results of operations on a specific date.
42. On the 20XX income statement, Red Door Boutique reported net income of $900,000. The company reported beginning total assets of $8,000,000 and ending total assets of $10,000,000. What is Red Door’s return on assets for 20XX?
43. 9.00%
44. 10.00%
45. 11.25%
46. 25.00%

#### Answer Key to Ten-Minute Quiz:

1. D

2. C

3. D

4. B   
Assets = Liabilities + Equity  
$485,000,000 = $163,000,000 + Equity  
Equity = $485,000,000 −$163,000,000 = $322,000,000

5. A

6. D

7. A

8. B  
Net Income (Loss) = Revenues −Expenses = $75,000 −$48,000 = $27,000

9. C

10. B  
Return on assets = Net Income / Average total assets = $900,000 / [($800,000,000 + $10,000,000) / 2] = $900,000 / $9,000,000 = 10.00%

**Extra Critical Thinking Questions**

**Decision Case 1-2**

Dave and Reba Guerrera saved all their married life to open a bed and breakfast (B&B) named Tres Amigos. They invested $100,000 of their own money, and the company issued common stock to them. The business then got a $100,000 bank loan for the $200,000 needed to get started. The company bought a rundown old Spanish colonial home in Tucson for $80,000. It cost another $50,000 to renovate. They found most of the furniture at antique shops and flea markets—for a total cost of $20,000. Kitchen equipment cost $10,000, and a computer system cost $2,000.

Prior to the grand opening, the banker requests a report on their activities thus far. The bank statement of Tres Amigos shows a cash balance of $38,000. Dave and Reba believe that the $38,000 represents net income for the period, and they feel pretty good about the results of their business. To better understand how well they are doing, they prepare the following income statement for presentation to the bank:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  |  |  |  |
| **Tres Amigos Bed and Breakfast** | | | | |
| Income Statement | | | | |
| Six Months Ended June 30, 20XX | | | | |
|  |  |  |  |  |
| Revenues: |  |  |  |  |
| Common stock |  | $ 100,000 |  |  |
| Bank loan |  | 100,000 |  |  |
| Total revenues |  |  |  | $ 200,000 |
| Expenses: |  |  |  |  |
| Cost of the house |  | 80,000 |  |  |
| Renovation to the house |  | 50,000 |  |  |
| Furniture expense |  | 20,000 |  |  |
| Kitchen equipment expense |  | 10,000 |  |  |
| Computer expense |  | 2,000 |  |  |
| Total expenses |  |  |  | 162,000 |
| Net Income |  |  |  | **$ 38,000** |
|  |  |  |  |  |

Requirements

1. Suppose you are the Guerreras’ banker, and they have given you this income statement. Would you congratulate them on their net income? If so, explain why. If not, how would you advise them to measure the net income of the business? Does the amount of cash in the bank measure net income? Explain.
2. Prepare the balance sheet for Tres Amigos based on these data.

**Decision Case 1-2: Solution**

**Requirement 1**

The banker would not congratulate the Guerreras for their net income because they have not measured net income properly. In fact, they have no net income at all. Net income is revenues minus expenses, and the Guerreras do not have any revenues or expenses. The amount of cash in the bank does not measure net income, as it is the result of a loan from the bank.

**Requirement 2**

|  |  |  |  |
| --- | --- | --- | --- |
| TRES AMIGOS BED AND BREAKFAST | | | |
| Balance Sheet | | | |
| June 30, 20XX | | | |
|  | |  | |
| Assets | | Liabilities | |
| Cash | $ 38,000 | Bank Loan Payable | $ 100,000 |
| Computer | 2,000 |  |  |
| Kitchen Equipment | 10,000 |  | |
| Furniture | 20,000 | Stockholders’ Equity | |
| Building ($80,000 + $50,000) | 130,000 | Common Stock | 100,000 |
| Total Assets | $ 200,000 | Total Liabilities and Stockholders’  Equity | $ 200,000 |
|  |  |  |  |

**Team Project 1-1**

You are opening Quail Creek Pet Kennel. Your purpose is to earn a profit, and you organize as a corporation.

Requirements

1. Make a detailed list of 10 factors you must consider to establish the business.
2. Identify 10 or more transactions that your business will undertake to open and operate the kennel.
3. Prepare the Quail Creek Pet Kennel income statement, statement of retained earnings, and balance sheet at the end of the first month of operations. Use made-up figures and include a complete heading for each financial statement. Date the balance sheet as of January 31, 20XX.
4. Discuss how you will evaluate the success of your business and how you will decide whether to continue its operation.

**Team Project 1-1: Solution**

**Requirement 1**

1. How to organize the business—as a proprietorship, a partnership, an LLC, or a corporation (You have decided to organize as a corporation.)
2. Where to locate the business
3. How much of your own time and money to commit to the business
4. How to finance the business—with your own personal money, with equity contributions from others, or through borrowing
5. How many people to employ for the business
6. How to measure the business’s success or failure; how to account for the assets, liabilities, and operations of the business
7. What type of animals to board (dogs only, dogs and cats, birds, reptiles, and so on)
8. Whether to sell pet foods, toys, and other supplies
9. Whether to offer obedience lessons and other pet training
10. How to advertise the business (newspapers, radio, posters, online)

Student answers may vary.

**Requirement 2**

1. Obtain equity financing to start the business
2. Purchase land and building
3. Renovate the building to make it suitable for a kennel
4. Purchase pet food and other supplies that will be needed to operate the kennel
5. Advertising
6. Earn service revenue
7. Pay utility bills
8. Pay for veterinarian services
9. Pay employee wages
10. Borrow money
11. Pay dividends

Student answers may vary.

**Team Project 1-1: Solution (cont’d)**

**Requirement 3**

|  |  |  |
| --- | --- | --- |
| QUAIL CREEK PET KENNEL | | |
| Income Statement | | |
| Month Ended January 31, 20XX | | |
|  |  |  |
| Revenue: |  |  |
| Service Revenue |  | $ 10,000 |
| Expenses:\* |  |  |
| Wages Expense | $ 2,000 |  |
| Supplies Expense | 400 |  |
| Advertising Expense | 300 |  |
| Utilities Expense | 100 |  |
| Total Expense |  | 2,800 |
| Net Income |  | $ 7,200 |
|  |  |  |

**\***Students may also include depreciation expense on the building.

|  |  |
| --- | --- |
| QUAIL CREEK PET KENNEL | |
| Statement of Retained Earnings | |
| Month Ended January 31, 20XX | |
|  | |
| Retained Earnings, January 1, 20XX | $ 0 |
| Net income for the month | 7,200 |
|  | 7,200 |
| Dividends | (2,000) |
| Retained Earnings, January 31, 20XX | $ 5,200 |
|  |  |

|  |  |  |  |
| --- | --- | --- | --- |
| QUAIL CREEK PET KENNEL | | | |
| Balance Sheet | | | |
| January 31, 20XX | | | |
|  | |  | |
| Assets | | Liabilities | |
| Cash | $ 1,500 | Accounts Payable | $ 1,000 |
| Supplies | 200 |  |  |
| Building | 25,000 | Stockholders’ Equity | |
| Land | 9,500 | Common Stock | 30,000 |
|  |  | Retained Earnings | 5,200 |
|  |  | Total Stockholders’ Equity | 35,200 |
| Total Assets | $ 36,200 | Total Liabilities And Stockholders’  Equity | $ 36,200 |
|  |  |  |  |

**Team Project 1-1: Solution (cont’d)**

**Requirement 4**

We evaluate the success of the business by considering its:

* Net income or net loss for the period, as reported on the income statement
* Financial position at the end of the period, as reported on the balance sheet

A profitable business that should continue is one that shows net income for the period, assets exceeding liabilities, and positive cash flow.

**Team Project 1-2**

You are promoting a rock concert in your area. Your purpose is to earn a profit, and you organize Concert Enterprises as a corporation.

Requirements

1. Make a detailed list of 10 factors you must consider to establish the business.
2. Describe 10 of the items your business must arrange in order to promote and stage the rock concert.
3. Prepare your business’s income statement, statement of retained earnings, and balance sheet on June 30, 20XX, immediately after the rock concert. Use made-up amounts and include a complete heading for each financial statement. For the income statement and the statement of retained earnings, assume the period is the three months ended June 30, 20XX.
4. Assume that you will continue to promote rock concerts if the venture is successful. If it is unsuccessful, you will terminate the business within three months after the concert. Discuss how you will evaluate the success of your venture and how you will decide whether to continue in business.

**Team Project 1-2: Solution**

(Suggested answers)

**Requirement 1**

1. How to organize the business—as a proprietorship, a partnership, an LLC, or a corporation (Assume you have decided to organize as a corporation.)
2. Where to locate the headquarters of the business
3. How much of your own time and money to commit to the business
4. How to finance the business—with your own personal money, with equity contributions from others, or through borrowing
5. How many people to employ for the business
6. How to measure the business’s success or failure; how to account for the assets, liabilities, and operations of the business
7. What type of music to feature; what age group or interest group to appeal to
8. Whether to sell concessions (food, drinks, T-shirts, and so on) yourself or to arrange for outsiders to sell concessions at the concert
9. How to advertise the business (newspapers, radio, posters, online)
10. Whether to sponsor the concerts yourself or to arrange for corporate or charitable organizations to sponsor the concerts

**Requirement 2**

1. Which band (or bands) to feature at the concerts
2. How much and when to pay the performers (flat rate or a percentage of gate receipts)
3. Where to stage the concerts and how to pay for the site rental
4. Need for city or county permits to stage a concert
5. How to ensure security at the concert
6. How to get people to come to the concert––how to advertise the concerts (newspapers, radio, posters, or other) and how much to pay for advertising
7. How to offer concessions (buy and sell them yourself or arrange for outside concessionaires). If outsiders, how will they be compensated—keep their own revenues or share them with you?
8. Need for traffic control if the crowd disrupts city traffic
9. Weather considerations if the concert is staged outdoors
10. Timing of the concert in relation to other events in the area at the time.

**Team Project 1-2: Solution (cont’d)**

**Requirement 3**

|  |  |  |
| --- | --- | --- |
| CONCERT ENTERPRISES | | |
| Income Statement | | |
| Three Months Ended June 30, 20XX | | |
|  |  |  |
| Revenue: |  |  |
| Ticket Sales Revenue |  | $ 300,000 |
| Concession Revenue |  | 50,000 |
| Total Revenue |  | 350,000 |
| Expenses: |  |  |
| Band Expense | $ 100,000 |  |
| Advertising Expense | 50,000 |  |
| Concession Expense | 20,000 |  |
| Rent Expense | 15,000 |  |
| Security Expense | 10,000 |  |
| Utilities Expense | 3,000 |  |
| Permits Expense | 2,000 |  |
| Total Expenses |  | 200,000 |
| Net Income |  | $ 150,000 |
|  |  |  |

**Team Project 1-2: Solution (cont’d)**

|  |  |
| --- | --- |
| CONCERT ENTERPRISES | |
| Statement of Retained Earnings | |
| Three Months Ended June 30, 20XX | |
| Retained Earnings, April 1, 20XX | $ 0 |
| Net income for quarter | 150,000 |
|  | 150,000 |
| Dividends | (10,000) |
| Retained Earnings, June 30, 20XX | $ 140,000 |
|  |  |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| CONCERT ENTERPRISES | | | | |
| Balance Sheet | | | | |
| June 30, 20XX | | | | |
|  | |  | | |
| Assets | | Liabilities | | |
| Cash | $ 136,000 | Accounts Payable | $ 7,000 | |
| Accounts Receivable | 8,000 |  |  | |
| Supplies | 4,000 | Stockholders’ Equity | | |
|  |  | Common Stock | | 1,000 |
|  |  | Retained Earnings | | 140,000 |
|  |  | Total Stockholders’ Equity | | 141,000 |
| Total Assets | $ 148,000 | Total Liabilities And Stockholders’  Equity | | $ 148,000 |
|  |  |  | |  |

**Requirement 4**

We evaluate the success of the business by considering its:

* Net income or net loss for the period, as reported on the income statement
* Financial position at the end of the period, as reported on the balance sheet

A profitable business that should continue is one that shows net income for the period, assets exceeding liabilities, and positive cash flow.

Communication Activity 1-1

Using 25 words or fewer, illustrate the accounting equation and explain each part of the accounting equation.

Communication Activity 1-1: Solution

Assets = Liabilities + Equity simply shows the resources that a business owns and the claims that others have against those resources (assets).