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Chapter F:1

Accounting and the Business Environment

Please note: Solutions to the Try It! and Quick Check answers now appear only in the Instructor's Solutions Manual, rather than appearing in the print and eTextbook versions for your students. All Try It! and Quick Check questions are assignable as book match (static) and algorithmic (similar to) versions via MyLab Accounting.

Chapter F: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. A Data Analytics in Accounting feature highlights the importance of data analytics skills for accountants.

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 owner's equity, 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

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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.

The chapter ends with how stakeholders use financial statements to evaluate business performance. The first ratio is introduced: Return on Assets (ROA). Real-world examples from the financial statements of Coca-Cola Company and PepsiCo, Inc. are used for comparison.

Chapter F:1: Learning Objectives

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

LO 2. Describe the organizations and rules that govern accounting

LO 3. Describe the accounting equation and define assets, liabilities, and equity

LO 4. Use the accounting equation to analyze transactions

LO 5. Prepare financial statements

LO 6. Use financial statements and return on assets (ROA) to evaluate business performance

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Chapter F:1: Teaching Outline with Lecture Notes

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

a) Define the term *accounting* and explain what accountants do

b) Exhibit F:1-1: Pathways Vision Model

Lecture Notes: The model emphasizes that good decisions have an impact on accounting judgments and economic activity, thus creating a circular flow of cause and effect. 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.

c) Differentiate between financial accounting and managerial accounting

d) Exhibit F: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).

e) Identify the users of accounting information:

i. Individuals

ii. Businesses

iii. Investors

iv. Creditors

v. Taxing authorities

Lecture Notes: The officers of a company may be (and probably are) owners 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.

f) Describe career options and certifications available in the accounting profession

Lecture Notes: Certified Public Accountants, or CPAs, are licensed professional accountants who serve the general public. Certified Management Accountants, or CMAs, are certified professionals

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who specialize in accounting and financial management knowledge. 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), Certified Global Management Accountant (CGMA), Chartered Accountant (CA), Certified Financial Planner (CFP), and many more.

Accountants also need data analytics skills to be successful. An understanding of how technology is used to process financial information is critical in today's job market.

g) Exhibit F:1-3: Comparison of Accounting Positions

Suggested In-Class Exercise: E-F:1-17

LO 2. Describe the organizations and rules that govern accounting

a) Identify accounting governing organizations, including the Financial Accounting Standards Board (FASB), the Security Exchange Commission (SEC), and the International Accounting Standards Board (IASB)

b) Describe Generally Accepted Accounting Principles (GAAP) and introduce the primary objective of financial reporting

c) Explain the economic entity assumption

i. Identify the different types of business organizations:

- Sole proprietorship
- Partnership
- Corporation
- Limited-liability company (LLC)

ii. Exhibit F:1-4: Business Organizations

d) Explain the cost principle

e) 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.

f) Explain the monetary unit assumption

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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.

g) Describe International Financial Reporting Standards (IFRS)

h) Ethics in accounting and business

i. Sarbanes-Oxley Act (SOX)

ii. 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 continues 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: E-F:1-18

LO 3. Describe the accounting equation and define assets, liabilities, and equity

a) The accounting equation: Assets = Liabilities + Equity

b) Define assets

c) Define liabilities

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d) 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

Suggested In-Class Exercise: E-F:1-21

LO 4. Use the accounting equation to analyze transactions

a) Transaction analysis for Smart Touch Learning

i. Transaction 1—Owner contribution

ii. Transaction 2—Purchase of land for cash

iii. Transaction 3—Purchase of supplies on account

iv. Transaction 4—Earning of service revenue for cash

v. Transaction 5—Earning of service revenue on account

vi. Transaction 6—Payment of expenses with cash

vii. Transaction 7—Payment on account (Accounts Payable)

viii. Transaction 8—Collection on account (Accounts Receivable)

ix. Transaction 9—Owner withdrawal of cash

b) Exhibit F:1-5: 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:

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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: owner's capital, owner's withdrawals, revenues, and expenses. Thus, there are four ways that equity can change during the year:

During the Year	Δ Assets =	Δ Liabilities	+ Owner's Capital
			+ Revenues
			− Expenses
			−Owner's Withdrawals

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: E-F:1-27

LO 5. Prepare financial statements

a) Exhibit F:1-6: Financial Statements

i. Exhibit F:1-7: Income Statement

ii. Exhibit F:1-8: Statement of Owner's Equity

iii. Exhibit F:1-9: Balance Sheet

iv. Exhibit F:1-10: 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 completed and 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 and is prepared first. The owner's equity statement shows the change in equity from profits earned less owner's withdrawals during the year and is prepared second. Balance sheets show the financial position of the company at specific points in time and is prepared third. The statement of cash flows explains the change in Cash in relation to everything else that changed during the year and is the final statement to be prepared.

Each financial statement should have a company name, a statement title, and some form of date. The income statement tracks profitability—revenues minus expenses. Remember that "profit" doesn't

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necessarily mean "money"; the profit may not have been collected in cash yet. The statement of owner's equity shows the changes in capital for a business entity over a period of time. As profits increase, owner's equity will increase; as withdrawals are paid, profits remaining in the business will decrease. The balance sheet shows the financial position 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 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 statement of cash flows 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 owner's equity balance does not represent the balance in the Cash account. Students sometimes think the owner can simply make withdrawals from profits earned at any given time. However, the income included in owner's 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: E-F:1-31, E-F:1-32, E-F:1-33

LO 6. Use financial statements and return on assets (ROA) to evaluate business performance

a) Review financial statements of PepsiCo, Inc.
(see http://www.pearsonhighered.com/millerpoindexter)

b) Explain return on assets (ROA)

Lecture Notes: Information presented in the financial statements is largely based on historical cost—the cost principle. 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

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liabilities! But, of course, even then the resulting value of owner's 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: E-F:1-39

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Chapter F:1: Handout for Student Notes

LO 1. Why is accounting important?

- Decision makers: The users of accounting information
  - Individuals
  - Businesses
  - Investors
  - Creditors
  - Taxing authorities
- Accounting matters

LO 2. What are the organizations and rules that govern accounting?

- Governing organizations
- Generally Accepted Accounting Principles (GAAP)
- The economic entity assumption

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- The cost principle
- The going concern assumption
- The monetary unit assumption
- International Financial Reporting Standards
- Ethics in accounting and business

LO 3. What is the accounting equation?

- Assets
- Liabilities
- Equity

LO 4. How do you analyze a transaction?

- Transaction analysis for Smart Touch Learning
  - Transaction 1—Owner contribution
  - Transaction 2—Purchase of land for cash

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- Transaction 3—Purchase of 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—Owner withdrawal of cash

LO 5. How do you prepare financial statements?

- Income statement
- Statement of owner's equity
- Balance sheet
- Statement of cash flows

LO 6. How do you use financial statements to evaluate business performance?

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