CHAPTER 1

Uses of Accounting Information and the Financial Statements

PLANNING MATRIX

	Learning Objective	Building Your Basic Knowledge and Skills			Enhancing Your Knowledge, Skills, and Critical Thinking
1.	Define *accounting* and describe its role in making informed decisions, identify business goals and activities, and explain the importance of ethics in accounting.	SE 1	E 1, 2, 3	P 3, 5, 7	C 1 C 6
2.	Identify the users of accounting information.		E 1, 3, 4		C 1
3.	Explain the importance of business transactions, money measure, and separate entity.	SE 2	E 1, 3, 5, 6, 7		
4.	Identify the three basic forms of business organization.	SE 2, 3	E 1, 4, 6, 14	P 4, 8	
5.	Define *financial position*, and state the accounting equation.	SE 4, 5, 6, 7	E 2, 8, 9, 12, 14		C 2 C 6
6.	Identify the four basic financial statements.	SE 8, 9	E 2, 9, 10, 11, 13, 14	P 1, 2, 3, 4, 5, 6, 7, 8, 9, 10	C 5
7.	Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.		E 2, 3, 15	P 5	C 3 C 4 C 5

MEMORANDA:

SE: Short Exercises

E: Exercises

P: Problems (Each problem has a User Insight question.)

C: Cases

All questions are in the text with related Learning Objectives (Stop, Think, and Apply).

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SUGGESTED INSTRUCTIONAL STRATEGY

Output Skills Developed:

Technical, Interpersonal

Related Learning Objective:

6

Instructional Strategy

Learning activity: Group work, game

Learning environment: Interactive groups within classroom

Learning tool: Textbook assignment: Problem 4 or 7 or Case 5

Steps to Implement

1. Divide the class into small groups. One quick way to form groups is to divide the number of students in class by three or four (the most effective group size for this activity). Ask students to count off from 1 to the maximum number of groups. Remind them not to forget their number. Have students get together after you give complete instructions. It will encourage a speedy transition, as this activity has a time limit.
2. Assign one of the learning tools. (If one of the problems was done for homework, use another one in this activity; it will reinforce learning.)
3. The first group to correctly complete the task wins. As the groups complete the task, they ask you to mark their completion time. (You may want to keep their responses until the time limit has expired. See Step 4.) The time limit is 25 minutes. If, for some reason, no group has the correct response in 25 minutes, give them additional time as deemed appropriate.
4. The winning group could present the correct responses to the entire class using the solution transparency and answer student questions. You may prefer to debrief this activity if time is limited. If you have group responses, a quick check will identify where the problems are.
5. Reward each of the winning group members with one or two extra quiz points, "$100 Grand" chocolate bars, novelty erasers, etc.

Assessment

Technical skills: Grade group written responses. Ask a related question on the next examination and/or quiz.

Interpersonal skills: Ask students to answer one or more of the following: How well did your group interact? How many were fully involved? What could your group do to improve next time?

RESOURCE MATERIALS AND OUTLINES

OBJECTIVE 1: Define *accounting* and describe its role in making informed decisions, identify business goals and activities, and explain the importance of ethics in accounting.

Summary Statement

Accounting is an information system that measures, processes, and communicates financial information about an economic entity. Accounting is a link between business activities and decision makers.

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A *business* is an economic unit that aims to sell goods and services to customers at prices that will provide an adequate return to its owners. The two major goals of all businesses are profitability and liquidity. *Profitability* is the ability to earn enough income to attract and hold investment capital. *Liquidity* is the ability to have sufficient cash to pay debts as they fall due. Businesses pursue their goals by engaging in (1) *operating activities,* which include selling goods and services to customers, employing managers and workers, and buying and producing goods and services; (2) *investing activities,* which involve spending the capital a company receives in productive ways to help it achieve its objectives; and (3) *financing activities,* which include obtaining funds to sustain operations. An important function of accounting is to provide *performance measures*, which indicate whether managers are achieving their business goals and whether the business activities are well managed.

The goal of accounting is to assist decision makers. *Management accounting* provides information to internal decision makers, such as managers, whereas *financial accounting* communicates financial information via *financial statements* to external decision makers. Most businesses publish financial statements that report their profitability and financial position.

Accounting includes the design of an information system that meets the user's needs.

Bookkeeping, a small but important aspect of accounting, deals with the mechanical, repetitive recordkeeping process. A *computer* is an electronic device that rapidly collects, organizes, and communicates vast amounts of information. A computer does not take the place of the accountant but rather is a tool used by the accountant to perform both routine bookkeeping chores and complex accounting calculations. A *management information system (MIS)* consists of the interconnected subsystems that provide the information needed to run a business. The accounting information system is an integral part of the management information system.

Ethics is the code of conduct that helps individuals in their everyday life distinguish right from wrong. Ethics is especially important in preparing financial reports because users of these reports must depend on the good faith of the people involved in their preparation. The intentional preparation of misleading financial statements is called *fraudulent financial reporting.* It can result from the distortion of records, falsified transactions, or the misapplication of various accounting principles.

In 2002, Congress passed the *Sarbanes-Oxley Act* to regulate financial reporting in public corporations. This legislation requires the chief executives and chief financial officers of all publicly traded U.S. companies to attest to the accuracy and completeness of the quarterly statements and annual reports that their companies file with the SEC.

New Concepts and Terminology

accounting; business; profitability; liquidity; operating activities; investing activities; financing activities; performance measures; management accounting; financial accounting; financial statements; bookkeeping; management information system (MIS); ethics; fraudulent financial reporting; Sarbanes-Oxley Act

Related Text Illustrations

Figure 1: Accounting as an Information System

Figure 2: Business Goals and Activities

Focus on Business Practice: What Does CVS Have to Say About Itself?

Focus on Business Practice: Cash Bonuses Depend on Accounting Numbers!

Focus on Business Practice: How Did Accounting Develop?

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Lecture Outline

I. Accounting is an information system that measures, processes, and communicates financial information.
   A. Accounting is a link between business activities and decision makers.
   B. Management must have a good understanding of accounting to set financial goals and make financial decisions.
   C. Management must not only understand how accounting information is compiled and processed but also realize that accounting information is imperfect and should be interpreted with caution.

II. A business is an economic unit that aims to sell goods and services to customers at prices that will provide an adequate return to its owners.
   A. Goals
      1. Profitability—earning a sufficient return to maintain owner interest
      2. Liquidity—having enough cash to pay debts as they come due
   B. Activities
      1. Operating—selling goods and services to customers; employing managers and workers; buying and producing goods and services; and paying taxes
      2. Investing—spending the capital a company receives in productive ways that help it achieve its objectives
      3. Financing—obtaining funds to begin operations and to continue operating
   C. Performance measures
      1. Performance measures relate to achieving goals and assessing the management of business activities.
      2. Financial analysis is the evaluation and interpretation of the financial statements and related performance measures.
      3. Performance measures must be crafted to motivate managers to make decisions that are in the best interest of the business.

III. Categories of accounting
   A. Management accounting—accounting information for internal decision makers
   B. Financial accounting—accounting information for external decision makers; reports are called financial statements.

IV. Ways in which accounting information is processed
   A. Bookkeeping is the mechanical and repetitive recordkeeping aspect of accounting.
   B. Computerized accounting
      1. Computerized accounting is useful for routine bookkeeping chores and complex accounting calculations.
      2. Computerized information is only as useful as the data input into the system.
   C. A management information system (MIS) consists of the interconnected subsystems that provide the information needed to run a business.

V. Ethical financial reporting
   A. Ethics is a code of conduct that addresses whether actions are right or wrong.
      1. Ethics in the preparation of financial reports is important because users of these reports must depend on the good faith of the people involved in their preparation.
      2. The intentional preparation of misleading financial statements is called fraudulent financial reporting.
      3. Fraudulent financial reporting can result from the distortion of records, falsified transactions, or the misapplication of various accounting principles.
      4. The motivation for fraudulent financial reporting could be to inflate the perceived value of a business, meet stockholders' and financial analysts' expectations, obtain financing, or receive personal gain.

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B. Congress passed the Sarbanes-Oxley Act in 2002 to regulate financial reporting in public corporations.

Teaching Strategy

A good place to begin is by discussing business goals and activities. Case 1 provides a good foundation for such discussion. This sets the stage for a discussion of accounting and how it helps businesses achieve goals and perform activities. Figure 2 in the text illustrates business goals and activities. Distinguish between profitability and liquidity and explain why a business must maintain both if it is to survive. The key components of the AICPA's definition of *accounting* are "useful," "financial information," and "decisions." This leads into the next learning objective, which focuses on those who rely on accounting information for decision making.

Figure 1 in the text not only illustrates accounting as an information system but also indicates the measurement, processing, and communication functions of accounting.

Students may have difficulty distinguishing between accounting and bookkeeping. Perhaps the use of a Venn diagram, with *bookkeeping* as a small circle within a much larger circle identified as *accounting,* will help them make the distinction. As they learn accounting, students will also tend to focus on the bookkeeping aspects only. Remind them that theory, terminology, financial statement disclosure, and other such topics also need to be learned.

Students often ask if computers have displaced accountants. Explain that although computers are a useful tool, particularly for routine, repetitive processing, higher-level analytical skills are required to interpret information, and professional judgment is required to make good decisions.

Distinguish between financial and managerial accounting. The discussion of internal versus external users can be integrated with the next learning objective on the users of accounting information.

Be sure to mention management's responsibility for ethical financial reporting, including the definition of fraudulent financial reporting and the significance of the Sarbanes-Oxley Act.

Short Exercise 1 can be used in class to test students' knowledge of terminology. Case 6 emphasizes the importance of cash flows and the goal of liquidity.

OBJECTIVE 2: Identify the users of accounting information.

Summary Statement

Basically, three groups use accounting information: management, outsiders with a direct financial interest, and outsiders with an indirect financial interest.

1. If a business is to survive, *management* must achieve profitability and liquidity. The company also has other goals, such as improving its products and expanding operations. Management directs the company toward these goals by making the right decisions.
2. Present or potential investors and present or potential creditors are considered outside users with a direct financial interest in a business. Investors use financial statements to assess the strength or weakness of the company, whereas creditors examine the financial statements to determine the company's ability to repay loans at the appropriate time.
3. Society as a whole, through its government officials and public groups, may be viewed as a financial statement user with an indirect financial interest in a business. Specifically, society includes (a) tax authorities, (b) regulatory agencies, and (c) other groups (such as labor unions and financial analysts). The *Securities and Exchange Commission (SEC),* a regulatory agency, has extensive reporting requirements for public companies.

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Managers in government and not-for-profit organizations such as hospitals, universities, professional organizations, and charities also make extensive use of financial information. In addition to financing, investing, and operating activities, these organizations have reporting responsibilities to authoritative bodies that hold them accountable for their financial performance.

New Concepts and Terminology

management; Securities and Exchange Commission (SEC)

Related Text Illustrations

Figure 3: The Users of Accounting Information

Focus on Business Practice: What Do CFOs Do?

Lecture Outline

I. Three major groups use accounting information.
   A. Management (internal users)
   B. Outsiders with a direct financial interest
      1. Present or potential investor
      2. Present or potential creditors
   C. People, organizations, and agencies with an indirect financial interest
      1. Tax authorities
      2. Regulatory agencies
         a. Securities and Exchange Commission (SEC)
      3. Other groups (labor unions, financial advisers, economic planners, etc.)

II. Government and not-for-profit organizations also use financial information.

Teaching Strategy

An interesting way to present this learning objective is to ask students to name the many users of financial information while you keep a list on the board (or overhead transparency, etc.). Students should know that the list in Figure 3 of the text, although ambitious, is not exhaustive. At the same time, you may want to ask them why each user would seek a company's financial information and whether each user is more interested in assessing profitability or liquidity.

Making the distinction between direct and indirect users, and between internal and external users, is helpful. Ask students how they have used accounting information.

Case 1 applies Learning Objectives 1 and 2 to a real-world company, Costco.

OBJECTIVE 3: Explain the importance of business transactions, money measure, and separate entity.

Summary Statement

To make an accounting measurement, the accountant must answer the following questions:

1. What is measured?
2. When should the measurement be made?
3. What value should be placed on what is measured?
4. How should what is measured be classified?

Accounting is concerned with measuring specific transactions of specific business entities in terms of money. *Business transactions* are economic events that affect the financial position of the business.

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Business transactions may involve exchanges of value (e.g., sales, borrowings, and purchases) or nonexchanges (the physical wear and tear on machinery and losses resulting from fire or theft).

The *money measure* concept states that business transactions should be recorded in terms of money. Financial statements are normally prepared in terms of the monetary unit of the business's country (dollars, pesos, etc.). When transactions occur between countries using different monetary units, the amounts must be translated from one currency to another using the appropriate *exchange rate.*

For accounting purposes, a business is treated as a *separate entity,* distinct from its owners, creditors, and customers.

New Concepts and Terminology

business transactions; money measure; exchange rate; separate entity

Related Text Illustration

Table 1: Examples of Foreign Exchange Rates

Lecture Outline

I. Four questions must be answered to make an accounting measurement.
   A. What is measured?
   B. When should the measurement be made?
   C. What value should be placed on what is measured?
   D. How should what is measured be classified?
II. A business transaction is an economic event that affects a business's financial position.
   A. It may involve an exchange of value (a purchase, sale, payment, collection, or loan).
   B. Alternatively, it may involve a "nonexchange" of value (physical wear and tear or losses from fire, flood, explosion, and theft).
III. The money measure concept states that a business transaction should be recorded in terms of money.
   A. Transactions between countries must involve the translation of amounts of money using the appropriate exchange rate.
IV. In accounting, a business is treated as a separate entity from its owners, creditors, and customers.

Teaching Strategy

List the four questions that must be answered before an accounting measurement can be made. Perhaps you can provide a sample transaction and have your students answer these questions. Students will already have a feel for what a business transaction is, but they probably will not know the difference between an exchange and a nonexchange transaction, so providing several examples may help. Refer to Table 1 on exchange rates, explain how they are used, and point out that they change daily. Explain how euros are replacing many European currencies. Obtain copies of annual reports prepared in other currencies to show students. Asking students to supplement the list of countries and their respective currencies in Table 1 may invite input from students of diverse backgrounds and is an opportunity to stress the global nature of business today.

Finally, explain that for accounting purposes, a business and its owner(s) are always considered separate entities. This concept can be reinforced by telling students that maintaining the separation between business and owner is often a challenge in a small family business when its owners write a check on the business's account for groceries or take a computer home or give their children a company automobile to drive. In the next learning objective, students learn that for legal purposes, a sole proprietorship or a partnership and its owners are *not* considered separate.

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Exercise 5 is a good one to reinforce the nature of a business transaction. Case 2 on the concept of an asset, using Southwest Airlines as an example, is excellent for class discussion.

OBJECTIVE 4: Identify the three basic forms of business organization.

Summary Statement

The three basic forms of business organization are sole proprietorships, partnerships, and corporations. Accountants recognize each form as an economic unit separate from its owners. A *sole proprietorship* is an unincorporated business owned by one person. A *partnership* is much like a sole proprietorship, except that it has two or more owners. A *corporation,* unlike a sole proprietorship or partnership, is a business unit chartered by the state and legally separate from its owners (the stockholders).

In this book, we begin with accounting for the sole proprietorship because it is the simplest form of accounting. At critical points, however, we call attention to its essential differences from accounting for partnerships and corporations.

New Concepts and Terminology

sole proprietorship; partnership; corporation;

Related Text Illustrations

Figure 4: Number and Receipts of U.S. Proprietorships, Partnerships, and Corporations

Focus on Business Practice: Are Most Corporations Big or Small Businesses?

Lecture Outline

I. There are three basic forms of business organization.
   - A. Sole proprietorship—one owner
     1. The owner takes all of the profits or losses of the business
     2. The owner also has unlimited liability
   - B. Partnership—two or more owners
     1. In a partnership two or more owners share profits or losses based on a predetermined arrangement
     2. Unlimited liability can be avoided by forming a limited liability partnership
   - C. Corporation—owned by many owners (the stockholders) but managed by a board of directors
     1. A corporation is a business unit chartered by the state (when articles of incorporation are filed) and considered a separate legal entity from its owners.
     2. The liability of corporate stockholders is limited to their investment.

Teaching Strategy

Point out that the sole proprietorship and the partnership are similar in many respects, but that the corporation is significantly different from the other two forms of business organization (in terms of formation, owners' liability, duration, transfer of ownership, and legal entity). Students have difficulty understanding the difference between the concepts of separate legal entities and separate accounting entities. Students often think that corporations always have multiple owners.

Relate material to the traditional form of organization of CPA firms. Tell students that pending legislation would permit CPA firms to incorporate. Ask students why firms might prefer incorporation.

Exercise 6 reviews the concepts from Learning Objectives 3 and 4.

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OBJECTIVE 5: Define *financial position,* and state the accounting equation.

Summary Statement

Financial position refers to the relationship between economic resources and equities at a given time, which is shown on the balance sheet. The *accounting equation* shows this relationship in mathematical form. The basic accounting equation is as follows:

Assets = Liabilities + Owner's Equity

Other forms of the equation are:

Assets – Liabilities = Owner's Equity

Assets – Owner's Equity = Liabilities

The left side of the basic accounting equation shows the resources (assets) of the business; the right side shows who provided these resources. The resource provider consists of owner (listed under "owner's equity") and creditors (evidenced by the existence of "liabilities"). Therefore, it is logical that the total dollar amount of assets must equal the total dollar amount of liabilities plus owner's equity.

Assets are the economic resources of a business. Examples of assets are cash, accounts receivable, inventory, buildings, equipment, patents, and copyrights.

Liabilities are the present obligations of a business. Examples of liabilities are money borrowed from banks, amounts owed to creditors for goods or services bought on credit, and taxes owed to the government.

Owner's equity represents the claims of the owner of a sole proprietorship to the assets of the business. It is equal to the *net assets,* or the assets that would be left after all liabilities are paid.

Owner's equity consists of the initial investment made by the owner, any subsequent contributions or investments made into the business, and earnings not distributed back to the owner in the form of dividends since the business' inception.

After the owner's investment, earnings that have been generated by the business's income-producing activities and kept for use in the business are added to owner's equity. Owner's equity is affected by three kinds of operating transactions: revenues, expenses, and dividends. *Revenues* are the increases in owner's equity resulting from the operation of the business. *Expenses* are the decreases in owner's equity that result from operating a business. When revenues exceed expenses, the difference is called *net income;* when expenses exceed revenues, the difference is called *net loss.*

New Concepts and Terminology

financial position; accounting equation; assets; liabilities; owner's equity; net assets; revenues; expenses; net income; net loss

Related Text Illustrations

Figure 5: The Accounting Equation

Lecture Outline

I. A balance sheet discloses a business's financial position by showing the relationship among assets, liabilities, and owner's equity.
II. The accounting equation is Assets = Liabilities + Owner's Equity.
III. Assets are a company's economic resources, such as cash, receivables, inventory, and equipment.

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IV. Liabilities are the present obligations of a business, such as amounts owed to banks, suppliers, employees, and others.
V. Owner's equity represents the claims of the owner of a business to the net assets of the business. It is made up of the owner's investment and all earnings not paid back to the owner in the form of dividends.
VI. Net income is the excess of revenues over expenses; net loss is the excess of expenses over revenues.

Teaching Strategy

To explain the concepts of financial position, the accounting equation, and the balance sheet, you can point out that all three represent two ways of looking at the same company: the assets are the resources of the company (the essence of which is "expected future benefit"), and the liabilities and owner's equity represent those who provided the resources (creditors and the owner).

To reinforce the elements of the accounting equation, use a local business and ask students what assets and liabilities it is likely to have. Students have difficulty grasping the concept of equity. Explain that it is a number that represents something and tell what it represents.

To illustrate the effects of transactions on the balance sheet equation, you may wish to discuss an end-of-chapter problem (such as Problem 2s) in which the balance sheet equation is updated for each transaction. Be sure to total columns after each transaction to illustrate that the accounting equation must always be in balance. A common misconception is that each transaction must have an increase and a decrease.

Students should be reminded that, although revenues and expenses have an effect on owner's equity, they do not appear on the balance sheet.

Short Exercises 6 and 7 and Exercise 8 are very good for in-class work.

OBJECTIVE 6: Identify the four basic financial statements.

Summary Statement

Accountants communicate their information through financial statements. The four basic statements are the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows.

The *income statement,* whose components are revenues and expenses, is perhaps the most important financial statement. Its purpose is to measure a business's profitability during a given period of time. The net income or net loss is used to update retained earnings on the statement of retained earnings. Net income (loss) also appears on the statement of cash flows.

The *statement of owner's equity* is a calculation of the changes in owner's capital during the accounting period. Owner's capital at the beginning of the period is the first item on the statement, followed by an addition for net income and a deduction for dividends. The ending figure is transferred to the owner's equity section of the balance sheet.

The *balance sheet* shows the financial position of a business on a specific date. The resources used in the business are called *assets,* debts of the business are called *liabilities,* and the owner's financial interest in the business is called *owner's equity.* Changes that occur in these accounts are reflected in the statement of cash flows.

The *statement of cash flows* provides users with information about the business's liquidity by disclosing all important financing, investing, and operating activities that affect its cash balance during the accounting period. *Cash flows* are the inflows and outflows of cash into and out of a business.

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Financing activities may include issuing or repaying debt. Investing activities may include selling a building or investing in stock. Operating activities include receipts from customers and payments to suppliers and others in the ordinary course of business.

Every financial statement has a three-line heading. The first line gives the name of the company, the second line gives the name of the statement, and the third line gives the relevant dates (the date of the balance sheet or the period of time covered by the other three statements).

Short Exercise 9 shows the interrelationship of the financial statements. Cases 5 and 6 are good summary cases for this chapter.

New Concepts and Terminology

income statement; statement of owner's equity; balance sheet; statement of cash flows; cash flows

Related Text Illustrations

Exhibit 1: Income Statement for Weiss Consultancy

Exhibit 2: Statement of Owner's Equity for Weiss Consultancy

Exhibit 3: Balance Sheet for Weiss Consultancy

Exhibit 4: Statement of Cash Flows for Weiss Consultancy

Exhibit 5: Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows for Weiss Consultancy

Lecture Outline

I. There are four basic financial statements that are interrelated.
    A. Income statement (also known as the statement of earnings or the profit and loss statement)
        1. Shows revenues earned and expenses incurred for a period of time
        2. Indicates profit or loss for an accounting period
    B. Statement of owner's equity (also known as the capital statement)
        1. Shows changes in the owner's capital account over a period of time
    C. Balance sheet (also known as the statement of financial position)
        1. Usually prepared as of the last day of the accounting period to show the organization's financial position (or status) as of that specific date
        2. Reflects the accounting equation in its structure
    D. Statement of cash flows
        1. Presents significant financing, investing, and operating activities (cash-generating and cash-using activities) during a given period
        2. Explains the reasons for changes in the organization's cash during an accounting period

Teaching Strategy

Explain the purpose of each financial statement and discuss how each is used by various user groups vis-à-vis evaluating profitability and liquidity. Then refer to Exhibit 5 in the text to show the relationship among the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. For example, students need to know why the income statement must be prepared first. Point out the common elements that appear on more than one statement. Stress that it is the ending owner's equity that appears on the balance sheet. Distinguish between a specific date and a period of time. Since the assets and liabilities of a business are changing from moment to moment, it is necessary to choose a cutoff date on which to measure them.

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Distinguish between net income on the income statement and net cash flows from operating activities on the statement of cash flows.

An end-of-chapter case (such as Case 5) can be used for reinforcement purposes.

OBJECTIVE 7: Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.

Summary Statement

Generally accepted accounting principles (GAAP) are the conventions, rules, and procedures that define acceptable accounting practice at a particular time. They arise from wide agreement on the theory and practice of accounting at a given time. These principles change continually as business conditions change and practices improve.

The financial statements of publicly held corporations are prepared by management but audited by a licensed professional, called a *certified public accountant (CPA),* so that the statements can be made more believable to the users. Before the *audit* (examination) can take place, however, the CPA must be independent of (without financial or other ties to) the client. On completion of the audit, the CPA reports whether the audited statements are "presented fairly in all material respects" and are "in conformity with generally accepted accounting principles." Because estimates and interpretations are made in the application of GAAP, auditors must employ their professional judgment in rendering an opinion.

The *Public Company Accounting Oversight Board (PCAOB)* is a governmental body created by the Sarbanes-Oxley Act to regulate the accounting profession.

The *Financial Accounting Standards Board (FASB),* an independent body, is the authoritative body in the development of GAAP. The FASB issues *Statements of Financial Accounting Standards.*

The *American Institute of Certified Public Accountants (AICPA),* the professional association of CPAs, influences accounting practice through the activities of its senior technical committees.

The *Securities and Exchange Commission (SEC)* is an agency of the federal government that has the legal power to set and enforce accounting practices for companies whose securities are traded by the general public.

The *Governmental Accounting Standards Board (GASB)* was established in 1984 and is responsible for issuing accounting standards for state and local governments.

Spurred by the growth of financial markets worldwide, the *International Accounting Standards Board (IASB)* develops international accounting standards.

The *Internal Revenue Service (IRS)* has its own set of rules that govern the assessment and collection of taxes. These rules, while sometimes contrary to GAAP, are an important influence on accounting practice.

Professional ethics is the application of a code of conduct to the practice of a profession. The accounting profession has developed a code that is intended to guide the accountant in carrying out his or her responsibilities to the public. In conformity with the AICPA's code for CPAs, the accountant must act with integrity, objectivity, independence, and due care.

1. *Integrity* means the accountant is honest, regardless of consequences.
2. *Objectivity* means the accountant is impartial and intellectually honest in performing his or her job.

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3. *Independence* means the accountant avoids all relationships that could impair, or even appear to impair, his or her objectivity, such as owning stock in a company being audited.

4. *Due care* means carrying out professional responsibilities with competence and diligence.

The *Institute of Management Accountants (IMA)* has a code of professional ethics, which stipulates that management accountants are to be competent in their jobs, to keep information confidential, to maintain integrity and avoid conflicts of interest, and to communicate information objectively and without bias.

New Concepts and Terminology

generally accepted accounting principles (GAAP); certified public accountant (CPA); audit; Financial Accounting Standards Board (FASB); International Accounting Standards Board (IASB); international financial reporting standards (IFRS); American Institute of Certified Public Accountants (AICPA); Public Company Accounting Oversight Board (PCAOB); Securities and Exchange Commission (SEC); Governmental Accounting Standards Board (GASB); Internal Revenue Service (IRS); professional ethics; integrity; objectivity; independence; due care; Institute of Management Accountants (IMA); corporate governance, audit committee

Related Text Illustration

Table 2: Large International Certified Public Accounting Firms

Lecture Outline

I. GAAP are the conventions, rules, and procedures that define acceptable accounting practice at a particular time.
   A. CPAs perform independent audits of businesses' financial statements.
   B. An audit results in a professional opinion as to whether the financial statements are in accordance with GAAP.

II. Organizations that issue accounting standards
   A. The FASB is responsible for developing GAAP.
   B. The IASB sets international accounting standards.
      1. More than 40 international financial reporting standards (IFRS) have been approved.

III. Other Organizations that influence GAAP
   A. The AICPA influences GAAP through advisory committees.
   B. The PCAOB is a governmental body created by the Sarbanes-Oxley Act to regulate the accounting profession.
   C. The SEC sets its own standards for companies whose securities are listed on the stock exchanges.
   D. The GASB was established to issue accounting standards for state and local governments.
   E. IRS guidelines are established to collect taxes but play an influential role in the establishment of accounting practices.

IV. It is important for CPAs to conform to their code of professional ethics because the public relies on them for the following:
   A. Integrity
   B. Objectivity
   C. Independence
   D. Due care
   E. Management accountants have a code of professional ethics that addresses competence, confidentiality, integrity, and objectivity.

V. Corporate governance
   A. Corporate governance is the oversight of a corporation's management and ethics by its board of directors

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B. Sarbanes-Oxley requires boards of directions to establish audit committees.

Teaching Strategy

Explain that GAAP are constantly evolving and are not like laws of science. Explain that GAAP are designed to “accurately measure the performance of businesses” and that the accountant, contrary to a common misconception, should not attempt to make a company look better on paper than it really is. Emphasize that GAAP are guidelines that require interpretation; they are not a rigid set of rules.

Be sure to explain that an audit report does not state whether the audited company is a good investment; it states only whether its financial statements are “presented fairly” in accordance with GAAP. Also discuss the importance of independence. Explain that an audit provides only reasonable, not absolute, assurance because it relies on test results from a sample of transactions.

An interesting discussion involves distinguishing between GAAP and tax law (Internal Revenue Code). Point out that the objective of tax law is to raise revenue for the government, not to accomplish the logical measurement of business income.

Explain the importance of ethics within the accounting profession and the possible consequences of being in violation of the professional code. The key terms *integrity, objectivity, independence,* and *due care* can help illustrate the concept. Describe some situations that typically create ethical dilemmas for accountants. Case 4 provides a good basis for such discussion.

REVIEW QUIZ

True-False

1. T F The Internal Revenue Service is the primary determiner of generally accepted accounting principles.
2. T F Dividends are disclosed on the income statement.
3. T F Net assets equal assets minus liabilities.
4. T F Liquidity means having enough funds on hand to pay debts when they fall due.
5. T F The operating officers are responsible for setting major corporate policy.
6. T F The purpose of the income statement is to show cash inflows and outflows.
7. T F The statement of retained earnings is a link between the income statement and the balance sheet.

Multiple Choice

8. The refusal of a CPA to audit a business in which he or she has a direct financial interest relates most closely to the ethical standard of
   a. subjectivity.
   b. independence.
   c. due care.
   d. integrity.
   e. objectivity.

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9. Generally accepted accounting principles
   a. apply only to the corporate form of business.
   b. may be found in their entirety in the Internal Revenue Code.
   c. are unwritten but generally understood.
   d. are based on laws of science and thus do not change.
   e. constitute accepted accounting theory and practice at a certain point in time.

10. A company's owners' equity is one-third of its total assets. Its liabilities total $200,000. What is the amount of its total assets?
    a. $50,000
    b. $100,000
    c. $150,000
    d. $200,000
    e. $300,000

11. Which of the following groups is a financial statement user with a *direct* financial interest?
    a. Investors
    b. Regulatory agencies
    c. Labor unions
    d. Financial analysts
    e. Taxing authorities

12. The heading "September 30, 20xx" would be appropriate for
    a. the statement of cash flows.
    b. the income statement.
    c. the statement of retained earnings.
    d. the balance sheet.
    e. all of the above statements.

13. Which of the following, if any, is *not* a satisfactory statement of the accounting equation?
    a. Assets + Liabilities = Owners' Equity
    b. Assets – Owners' Equity = Liabilities
    c. Assets = Liabilities + Owners' Equity
    d. Assets – Liabilities = Owners' Equity
    e. All of the above are acceptable.

14. The organization that has the most impact on generally accepted accounting principles is the
    a. PCAOB
    b. SEC
    c. FASB
    d. AICPA
    e. IMA

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15. Which of the following forms of business organization are considered entities separate from their owners for *accounting* purposes?
    a. Sole proprietorship
    b. Partnership
    c. Corporation
    d. Sole proprietorships and partnerships
    e. All of the above

16. Sarbanes-Oxley Act of 2002 greatly changed the regulation of accounting by establishing the
    a. PCAOB
    b. SEC
    c. FASB
    d. AICPA
    e. IMA

17. Before the statement of retained earnings can be prepared, which of the following statements must be prepared?
    a. Balance sheet
    b. Income statement
    c. Statement of stockholders' equity
    d. Statement of cash flows
    e. None of the above

ANSWERS TO REVIEW QUIZ

True-False

1. F
2. F
3. T
4. T
5. F
6. F
7. T

Multiple Choice

8. b
9. e
10. e
11. a
12. d
13. a
14. c
15. e
16. a
17. b

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CHAPTER 2

Analyzing Business Transactions

PLANNING MATRIX

	Learning Objective	Building Your Basic Knowledge and Skills			Enhancing Your Knowledge, Skills, and Critical Thinking
1.	Explain how the concepts of recognition, valuation, and classification apply to business transactions and why they are important factors in ethical financial reporting.	SE 1, 2, 3	E 1, 3, 4	P 4, 7	C 1 C 3 C 4 C 5
2.	Explain the double-entry system and the usefulness of T accounts in analyzing business transactions.	SE 4	E 1, 5, 6	P 1, 6	
3.	Demonstrate how the double-entry system is applied to common business transactions.	SE 2, 5, 6	E 1, 7, 8, 9, 11, 17	P 2, 3, 4, 5, 7, 8, 9, 10	C 4
4.	Prepare a trial balance, and describe its value and limitations.	SE 7	E 2, 10, 12, 13, 14	P 3, 4, 5, 7, 8, 10	
5.	Show how the timing of transactions affects cash flows and liquidity.	SE 8	E 2, 15	P 3, 5, 8, 10	C 2
Supplemental Objective					
6.	Define the *chart of accounts*, record transactions in the general journal, and post transactions to the ledger.	SE 9, 10, 11	E 16, 17, 18	P 5, 8	

MEMORANDA:

SE: Short Exercises

E: Exercises

P: Problems (Each problem has a User Insight question.)

C: Cases

All questions are in the text with related Learning Objectives (Stop, Think, and Apply).

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SUGGESTED INSTRUCTIONAL STRATEGY

Output Skills Developed:

Technical

Related Learning Objectives:

2, 5

Instructional Strategy

Learning activity: Game, team tasks

Learning environment: Interactive groups within the classroom

Learning tool: Textbook assignment Exercise 6

Steps to Implement

1. Use a *Jeopardy* game format to reinforce student comprehension of account classifications and normal balances. At least one class prior to the game, let students know about the game and the learning objectives to be covered.
2. Students could form their own teams between classes. Specify team size. (Three is recommended.) Remind teams that they must sit together in class. The first group member to class picks team seats, which have been labeled by the instructor with tags showing large-print numbers. Students wear tags during the game to make scoring easier.
3. Using information from the exercise (and elsewhere), prepare a list of account items, such as "accounts payable classification" or "inventory normal balance." Responses could be in *Jeopardy* form, such as "What is a liability?" or "What has a normal debit balance?" Particularly tough questions could be identified as Double Jeopardy items worth double points—for example, having to answer both account classification and normal balance within the time limit.
4. As a preliminary round, each student participates by writing his or her own answers on a piece of paper. Each individual score is treated as part of a team grade. Each team member answers several items on a sheet of paper. It must be legible because another team will grade it. If it can't be read, it is counted as incorrect. As the instructor calls out the account, each group member writes the classification and/or normal balance. If you want to make it tougher, make the time limit to answer ten seconds or less. A stopwatch is helpful.
5. To determine who moves on to the final round, have Team 1 give its answer sheet to Team 2, Team 2 to Team 3, etc., until the last team gives its answer sheet to Team 1. Each correct answer wins one point. Double Jeopardy answers are worth two points.
6. The teams with the highest scores for round one move on to the final round. Assign a team name or keep the same number. Tags with the group number should be easily visible from the scorer's viewpoint. Ask one or two trusted students to keep score.
7. Final round format is the instructor asking one team at a time a different question to be answered within five seconds. A limited use of recycled questions is OK as long as the same team does not get the same question. This process continues for a stated number of rounds. Sudden death could be played if more than one team remains.
8. Consider performance-based rewards; for example, the team with the highest score could earn bonus quiz points or have a quiz waived. If only one team has the top score, honor winners as reigning team champions. Present first-place ribbons.

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Evaluation

Technical skills: Ask related questions on the next examination or quiz

RESOURCE MATERIALS AND OUTLINES

OBJECTIVE 1: Explain how the concepts of recognition, valuation, and classification apply to business transactions and why they are important factors in ethical financial reporting.

Summary Statement

Before recording a business transaction, the accountant must determine three things:

1. When the transaction occurred (the *recognition* issue)
2. What value to place on the transaction (the *valuation* issue)
3. How the components of the transaction should be categorized (the *classification* issue)

A sale is recognized (entered in the accounting records) when the title to merchandise passes from the supplier to the purchaser, regardless of when payment is made or received. This is called the *recognition point.*

The dollar value of any item involved in a business transaction is its original *cost* (also called *historical cost*). Generally, any change in value subsequent to the transaction is not reflected in the accounting records. This practice, which conforms to the *cost principle,* is preferred by accountants because the cost, or exchange price, is verifiable and objective. The *exchange price* results from an agreement between the buyer and seller that can be verified by evidence created at the time of the transaction.

Every business transaction is classified by means of categories called *accounts*. Each asset, liability, stockholders' equity, revenue, and expense has a separate account.

Recognition, valuation, and classification are important factors in ethical financial reporting. These guidelines are intended to help managers meet their obligations to the company's owners and to the public.

New Concepts and Terminology

recognition; recognition point; valuation; fair value; cost principle; classification

Related Text Illustrations

Focus on Business Practice: Accounting Policies: Where Do You Find Them?

Figure 1: The Role of Measurement Issues

Focus on Business Practice: The Challenge of Fair Value Accounting

Focus on Business Practice: No Dollar Amount: How Can That Be?

Lecture Outline

I. Three measurement issues must be resolved before a business transaction is recorded.
   A. **Recognition** issue—When should the transaction be recorded?
   B. **Valuation** issue—What dollar amount should be recorded?
   C. **Classification** issue—Which accounts are affected?
II. A sale is recognized when title passes to the buyer (recognition point).
III. Transactions should be recorded at their original cost (historical cost).

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A. The **fair value** is the exchange price, which results from an agreement between the buyer and seller that can be verified by evidence at the time of the transaction.
B. Assets are valued at the initial fair value or cost unless there is evidence that the fair value has changed and an adjustment must be made.

IV. Transactions must classified according to the appropriate categories or accounts.
IV. Recognition, valuation, and classification are important factors in ethical financial reporting.

Teaching Strategy

Many students approach the topic of measurement (as well as accounting itself) as though it is fairly cut-and-dried. Nevertheless, they must realize that there are often several ways to approach the recognition, valuation, and classification issues, only one of which typically follows GAAP. Emphasize that the recognition problem is not always easily solved and that the historical cost principle is somewhat controversial.

Explain why a business transaction cannot be recorded until the three measurement issues have been addressed.

Emphasize that as a user of financial statements, it is important to understand that the balance sheet does not aim to show what a business is worth. Give an example using land or a building, which generally increases in value over time.

Mention some exceptions to the basic recognition rule of recording transactions only when title transfers. Cases 1 and 3, Exercises 3 and 4, or Short Exercise 1 in the text illustrate this learning objective. You may also present a basic journal entry and ask students to point out the portion of the journal entry that refers to recognition, valuation, and classification. Short Exercise 2 provides an excellent opportunity for students to integrate recognition, valuation, and classification issues.

OBJECTIVE 2: Explain the double-entry system and the usefulness of T accounts in analyzing business transactions.

Summary Statement

The *double-entry system* of accounting requires that each transaction be recorded with at least one debit and one credit, and that the total dollar amount of the debits must equal the total amount of the credits.

Accounts are the basic storage units for accounting data and are used to accumulate amounts from similar transactions. An account in its simplest form, a *T account,* has three parts:

1. A title, which identifies the asset, liability, or owner's equity account
2. A left side, which is called the *debit* side
3. A right side, which is called the *credit* side

At the end of an accounting period, the accountant must determine the *balance* in each account to prepare the financial statements. Three steps are followed to determine these account balances:

1. Foot (add up) the debit entries. The *footing* (total) should be written in small numbers beneath the last entry.
2. Foot the credit entries.
3. Subtract the smaller total from the larger. A debit balance exists when total debits exceed total credits; a credit balance exists when the opposite is the case.

To determine which accounts are debited and which are credited in a given transaction, the accountant uses the following rules:

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1. Increases in assets are debited.
2. Decreases in assets are credited.
3. Increases in liabilities and owner's equity are credited.
4. Decreases in liabilities and owner's equity are debited.
5. Revenues increase owner's equity and are therefore credited.
6. Expenses decrease owner's equity and are therefore debited.

When more increases than decreases have been recorded for an account (the usual case), then its balance (debit or credit) is referred to as its *normal balance.* For example, assets have a normal debit balance. Typical owner's equity accounts are Owner's Capital and Withdrawals. A separate account is kept for each type of revenue and expense. The exact revenue and expense accounts used vary depending on the type of business and the nature of its operations.

New Concepts and Terminology

double-entry system; accounts; T account; debit; credit; footings; balance; normal balance

Related Text Illustrations

Table 1: Normal Account Balances of Major Account Categories

Figure 2: Relationships of Owner's Equity Accounts

Lecture Outline

- I. Describe the nature of the double-entry system of accounting.
  - A. Principle of duality
- II. Accounts are the basic storage units for accounting data and are used to accumulate amounts from similar transactions.
- III. A T account (the simplest form of an account) has three parts.
  - A. A title expressing the name of the asset, liability, etc.
  - B. A debit (left) side
  - C. A credit (right) side
- IV. Demonstrate how account balances are determined.
- V. State the rules of double entry.
  - A. Increases in assets are debited.
  - B. Decreases in assets are credited.
  - C. Increases in liabilities and owner's equity are credited.
  - D. Decreases in liabilities and owner's equity are debited.
  - E. Increases in revenues are credited.
  - F. Increases in expenses are debited.
- VI. The normal balance of an account is what it takes (debit or credit) to increase the account.
- VII. Discuss typical owner's equity accounts, such as Owner's Capital and Withdrawals.

Teaching Strategy

Students will wonder why the rules of debit and credit are as they are. Simply state that they are an arbitrary set of rules whose careful interrelationships make them work. In addition, students need to dispel any preconceived notions as to what debit and credit imply (good, bad, and so on). One way to accomplish this is to make an imaginary T account of the classroom. Students are assigned roles (debit or credit) depending on which side of the room they are seated. Ask the debits if they like being debits or would they rather be credits. If a student indicates a preference, ask why. It may indicate a

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misconception about what debit and credit really mean. Tell students who work in a bank to reverse what they have learned about debits and credits. Finally, explain the beauty of the double-entry system.

Students need to know that transactions are not recorded in T accounts in practice, but T accounts are used by accountants to analyze complex transactions.

Memorization and repetition are the keys to mastering the rules of debit and credit. Drill students until they know the rules perfectly. The double-entry rules do not require as much memorization as students often think. Point out that if they know the accounting equation and that assets are increased with debits, they can reason through the rest of it. For example, liabilities and owner's equity must be increased with credits because they are on the opposite side of the equation. Accounts that increase equity (e.g., revenues) have the same rules, whereas accounts that decrease equity (e.g., expenses, withdrawals) have the opposite rules.

Lead students through the process of determining account balances. Point out that negative balances do not exist. The balance in an account is simply the absolute difference between the debits and credits. Exercise 6 is excellent for reinforcing account terminology, classification, and normal balances.

OBJECTIVE 3: Demonstrate how the double-entry system is applied to common business transactions.

Summary Statement

Analyzing and applying transactions is a five-step process:

1. State the transaction.
2. Analyze the transaction to determine which accounts are affected. Information about transactions comes from *source documents* such as invoices, checks, receipts, and contracts.
3. Apply the rules of double-entry accounting by using T accounts to show how the transaction affects the accounting equation.
4. Show the transaction in *journal form*. In journal form, the date, the debit account, and the debit amount are recorded on one line and the credit account (indented) and credit amount are recorded on the next line.
5. Provide a comment that will help you apply the rules of double-entry accounting.

The following journal entries are introduced in this learning objective:

Account	Debit	Credit
Cash	XX (amount invested)	
Owner's Capital		XX (amount invested)
Owner invested cash in business		
Office Supplies	XX (purchase price)	
Accounts Payable		XX (amount to be paid)
Purchased office supplies on credit		
Prepaid Rent	XX (amount paid)	
Cash		XX (amount paid)
Paid rent in advance		
Office Supplies	XX (amount paid)	
Accounts Payable		XX (amount paid)
Purchase of office supplies on credit		

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Office Equipment	XX (purchase price)
Cash	XX (amount paid)
Accounts Payable	XX (amount to be paid)
Purchased office equipment with partial payment	
Accounts Payable	XX (amount paid)
Cash	XX (amount paid)
Paid partial payment on a liability	
Cash	XX (amount received)
Design Revenue	XX (amount earned)
Received payment for services rendered	
Accounts Receivable	XX (amount to be received)
Design Revenue	XX (amount earned)
Rendered service, payment to be received at later time	
Cash	XX (amount received)
Unearned Design Revenue	XX (amount to be earned)
Received payment for services to be performed	
Cash	XX (amount received)
Accounts Receivable	XX (amount received)
Received payment for services previously performed	
Wages Expense	XX (amount incurred)
Cash	XX (amount paid)
Paid wages for the period	
Utilities Expense	XX (amount incurred)
Accounts Payable	XX (amount to be paid)
Recorded utility bill, payment to be made at later time	
Owner’s Withdrawals	XX (amount withdrawn)
Cash	XX (amount paid)
Owner withdrew cash from business	

(No entry is made when an order is placed.)

New Concepts and Terminology

source documents; journal form

Related Text Illustration

Exhibit 1: Summary of Transactions of Miller Design Studio

Lecture Outline

I. Explain the five-step process for analyzing and applying transactions.
   A. State the transaction.

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B. Analyze the transaction to determine which accounts are affected and how (increased or decreased).
C. Apply the rules of double-entry accounting using T accounts to show how the transaction affects the accounting equation.
D. Show the transaction in journal form.
E. Provide a comment that will help you apply the rules of double-entry accounting.

Teaching Strategy

Tell students they must answer (at least in their minds) the following questions before preparing a journal entry:

1. What is the transaction in words?
2. Which accounts are involved, and how are they classified (asset, liability, etc.)?
3. Is each account increased or decreased?
4. Based on the foregoing answers, which rules of debit and credit apply, and what is the correct journal entry?

Writing out the answers to these four questions for every transaction analyzed is helpful at first. Short Exercise 5 or 6 and Exercise 7 or 9 are helpful to quickly illustrate this learning objective. Analyzing the transactions in Problems 2, 3, 4, 5, 7, and 8 in terms of debits and credits is helpful for driving home the point. Case 4 is a good application of this learning objective to real-world companies.

OBJECTIVE 4: Prepare a trial balance, and describe its value and limitations.

Summary Statement

Before financial statements are prepared, the accountant must double-check the equality of the debits and credits in the accounts. This is done formally by means of a *trial balance.* If the trial balance does not balance, one or more errors have been made in the journal, ledger, or trial balance. Once the errors have been located and the trial balance is in balance, the financial statements can be prepared. It is possible, however, to make errors that do not cause the trial balance to be out of balance (that is, errors that are not detected through the trial balance).

To summarize, proper accounting procedure requires that certain steps be followed (additional steps are introduced in subsequent chapters):

1. Journalize transactions as they occur.
2. Post the journal entries to the ledger accounts when convenient.
3. Prepare a trial balance at the end of each accounting period.
4. Use the trial balance to prepare the financial statements.

New Concepts and Terminology

trial balance

Related Text Illustrations

Exhibit 2: Trial Balance

Focus on Business Practice: Are All Trial Balances Created Equal?

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Lecture Outline

I. A **trial balance** tests the equality of debits and credits in the ledger before the financial statements are prepared. A three-step process is followed.
   A. List each ledger account and its debit or credit balance.
   B. Add each column.
   C. Compare the column totals.
II. If the trial balance does not balance, one or more of the following has occurred:
   A. A debit was entered as a credit, or vice versa.
   B. The balance was computed incorrectly.
   C. The balance was carried to the trial balance incorrectly.
   D. The trial balance was summed incorrectly.
III. It is possible to make an error in the records that does not cause the trial balance to be out of balance, such as the following:
   A. A transaction was omitted or entered twice.
   B. Both debit and credit amounts are incorrect but equal.
   C. The wrong account was debited or credited.

Teaching Strategy

Students need to know that a trial balance is not a financial statement to be published and that it is prepared only at the end of the accounting period. They also need to know that it tests the equality of the ledger before financial statement preparation and that, even if it balances, it may show an incorrect balance.

Point out that the accounts are listed in Exhibit 2 in the same order in which they are listed in the ledger. Emphasize that only account balances are entered, not footings. Tell students that if a zero balance exists, the account need not be listed in the trial balance.

Short Exercise 7 and Exercises 10, 12, 13, and 14 give students the opportunity to prepare a trial balance and to recognize which errors cause it to be out of balance. Assigning Problem 5 or 8 is an excellent way to tie all the concepts together.

OBJECTIVE 5: Show how the timing of transactions affects cash flows and liquidity.

Summary Statement

Because the timing of cash flows is critical to maintaining adequate liquidity to pay bills, users of financial information must understand the difference between transactions that generate cash and those that do not. To maintain liquidity, the management of a company must carefully plan the company's needs for cash.

Related Text Illustrations

Focus on Business Practice: Should Earnings Be Aligned with Cash Flows?

Figure 3: Transactions of Miller Design Studio

Lecture Outline

I. Discuss the importance of maintaining good liquidity.
II. Discuss the timing of cash flows in maintaining a company's adequate liquidity to pay bills.

Teaching Strategy

Walk students through Figure 3, stressing the roles of Accounts Receivable and Accounts Payable in managing cash flows and liquidity. Then assign Exercise 15 and use Case 2 for class discussion.

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SUPPLEMENTAL OBJECTIVE 6: Define the *chart of accounts,* record transactions in the general journal, and post transactions to the ledger.

Summary Statement

All of a company's accounts are contained in a book called the *general ledger,* or simply the *ledger*. In a manual system, each account appears on a separate page, and the accounts generally are in the following order: assets, liabilities, owner's equity, revenues, and expenses. A listing of the accounts with their respective account numbers, called a *chart of accounts,* is presented at the beginning of the ledger for easy reference.

Although the accounts used by companies vary, some are common to most businesses. Typical asset accounts are Cash, Accounts Receivable, Notes Receivable, Prepaid Expenses, Land, Buildings, and Equipment. Typical liability accounts are Accounts Payable and Notes Payable.

As transactions occur, they are recorded initially and chronologically in a book called the *journal.* The *general journal* is the simplest and most flexible type of journal. Each transaction *journalized* (recorded) in the general journal contains (1) the date, (2) the account names, (3) the dollar amounts debited and credited, (4) an explanation, and (5) the account identification numbers, if appropriate. A line should be skipped between each *journal entry,* and more than one debit or credit may be entered for a single transaction.

In the construction of a ledger in practice, the *ledger account form,* rather than the T account form, is used. The four-column type is illustrated in the text.

All journal entries must be posted to the ledger accounts. *Posting* is a transferring process that results in an updated balance for each account. Not only must the dates and amounts be transferred and new account balances computed, but the Post. Ref. columns must also be used for cross-referencing between the journal and the ledger.

Ruled lines appear in financial reports before each subtotal, and a double line is customarily placed below the final amount. Although dollar signs are required in financial statements, they are omitted in journals and ledgers. On ruled paper, commas and periods are omitted, and a dash is customarily used to designate zero cents.

New Concepts and Terminology

general ledger; chart of accounts; journal; journal entry; journalizing; general journal; ledger account form; posting

Related Text Illustrations

Figure 4: Analyzing and Processing Transactions

Exhibit 3: Chart of Accounts for a Small Business

Exhibit 4: The General Journal

Exhibit 5: Accounts Payable in the General Ledger

Exhibit 6: Posting from the General Journal to the Ledger

Lecture Outline

I. Chart of Accounts
   A. An account is the basic storage unit for accounting data.
   B. An account occupies its own page in the **general ledger**.
   C. A **chart of accounts** lists all the accounts in the ledger.

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D. Discuss typical asset accounts, such as Cash, Accounts Receivable, Notes Receivable, Supplies, Inventory, Prepaid Expenses, Land, Buildings, and Equipment.
E. Discuss typical liability accounts, such as Accounts Payable, Notes Payable, Wages Payable, Income Taxes Payable, Rent Payable, Interest Payable, and Unearned Revenue.

II. General Journal
A. Transactions are initially recorded in the journal (book of original entry).
B. Every journal entry contains five components.
1. The date
2. The account names
3. The dollar amounts debited and credited
4. An explanation
5. The account identification number, if appropriate
C. A space should be skipped between journal entries.
D. A compound entry is an entry with more than one debit or credit.
E. Illustrate the ledger account form, and state its advantage over the T account form.

III. Journal entries are posted (transferred) to the ledger when convenient (usually daily).
A. Post the date and amounts.
B. Compute a new account balance.
C. Place the journal page number in the Post. Ref. column of the ledger account.
D. Place the account number in the Post. Ref. column of the journal.

IV. Rules and customs regarding ruled lines, dollar signs, commas, and periods should be followed.

Teaching Strategy

It is assumed that students have read the entire chapter and thus have knowledge of a journal and a ledger. Point out how difficult, if not impossible, it would be to prepare financial statements directly from the journal (that is, without the use of a ledger). In effect, a ledger is merely a filing system in which each account occupies its own page. Pass around a general ledger from a manual system and one from a computerized system.

Refer students to Exhibit 3, stressing that the chart of accounts is merely a table of contents to the ledger. Point out the traditional order of accounts (the same as in the ledger) and the need for flexibility in the numbering scheme. In addition, state the restrictive nature of the accounts—that is, students must use the exact titles that have been established and cannot use phrases for account names (such as “cash paid” or “equipment purchased”).

It may be useful to again define asset, liability, and owner’s equity before discussing the individual accounts. While you discuss the accounts, emphasize that establishing account names for a business is a flexible process (and that similar items are frequently “lumped together” into one account). Students often do not distinguish accounts from transactions at this point. Clarify the difference.

Ask students to differentiate between supplies and equipment and between inventory and equipment. Students will have difficulty understanding the difference between Accounts Receivable and Notes Receivable and between Accounts Payable and Notes Payable. Simply state that the difference lies in the existence or nonexistence of a promissory note.

Students invariably misunderstand the nature of unearned revenues. Explain how they arise, and indicate that they are liabilities, not revenues.

Students often have difficulty differentiating between an asset and a revenue and between a liability and an expense. Explain that because we use a double-entry system, a single transaction such as a cash sale results in the recording of both an asset (cash) and a revenue. Providing goods or services results in a revenue; what you receive in exchange results in an asset.

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Short Exercise 3 and Exercise 6 are excellent classroom exercises to reinforce the classification of accounts.

At this point, students may be confused about the proper order of procedure. Explain that, even though the financial statements and ledger were introduced before the journal, the correct order of procedure at this point is (1) analyze the transactions, (2) enter transactions into the general journal, (3) post from the journal to the ledger, and (4) prepare the trial balance.

Students need to be shown the variety of conventions normally employed with the general journal (such as proper use of the money columns, placement of all debits first, indention of credits, skipping of a space between entries, and so on). They will worry about what exactly to include in the explanation. Exercise 18 and Problems 5 and 8 provide good practice in preparing journal entries.

Contrast the general journal form (Exhibit 4) with the general ledger form (Exhibit 5). Acknowledge that transactions are recorded twice.

Suggest to students that we do away with the journal and just keep a ledger. What would be missing? Then suggest we do away with the ledger. What information would be lacking? A helpful analogy is to have them picture the general journal as a bagful of mail and the general ledger as several slots into which the mail (journal entries) is sorted.

Point out that posting is not difficult. All of the analysis has already been done. Posting is a clerical process. Explain that journalizing and posting occur simultaneously in a computerized system.

Common errors that students make regarding the ledger are to skip a line between postings and to make use of the "item" column when it is normally ignored.

When posting, students may either forget to use or be confused about the Post. Ref. columns in the general journal and ledger. In addition, they need to know how to compute an account balance (that is, how to add a debit to a debit balance, a credit to a credit balance, and a debit-credit posting combination). Use of Exhibit 6 helps to explain the posting procedure.

Exercise 18 provides an excellent classroom exercise for the posting aspects of this learning objective.

REVIEW QUIZ

True-False

1. T F The Revenue from Services account is increased with a debit.
2. T F The accounts in the trial balance are normally listed in the same order as in the general ledger.
3. T F The balance sheet figure for buildings should be based on the buildings' current market value.
4. T F The recognition issue refers to the difficulty in deciding when a business transaction should be recorded.
5. T F Unearned Art Fees is classified as a liability.
6. T F Notes Payable is an account used by a company that issues a promissory note to a creditor.
7. T F All transactions are initially recorded in the general ledger.

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Multiple Choice

8. Which of the following accounts is increased with a debit?
   a. Unearned Revenue
   b. J. Jones, Capital
   c. Advertising Fees Earned
   d. Withdrawals
   e. Wages Payable

9. If Accounts Payable has debit postings of $32,000, credit postings of $25,000, and an ending normal balance of $47,000, which of the following was its beginning balance?
   a. $7,000
   b. $39,000
   c. $40,000
   d. $47,000
   e. $54,000

10. When cash is received in advance of performing a service, the accountant
    a. makes no journal entry because performance of the service has not yet begun.
    b. debits Unearned Revenue and credits Cash.
    c. debits Cash and credits Revenue from Services.
    d. debits Unearned Revenue and credits Revenue from Services.
    e. debits Cash and credits Unearned Revenue.

11. Net income does not appear on which of these financial statements?
    a. Income statement
    b. Statement of Cash Flows
    c. Balance Sheet
    d. Statement of Owner's Equity
    e. Statement of Cash Flows and Statement of Owner's Equity

12. The journal entry to record the completion of a service for which payment has *not* been received is a debit to
    a. Revenue from Services and a credit to Accounts Payable.
    b. Accounts Receivable and a credit to Revenue from Services.
    c. Revenue from Services and a credit to Unearned Revenue.
    d. Cash and a credit to Revenue from Services.
    e. none of the above; no entry is made until the cash has been received.

13. Prepaid Insurance is classified as a(n)
    a. asset.
    b. liability.
    c. owner's equity account.
    d. revenue.
    e. expense.

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14. Which of the following errors can cause the trial balance to be out of balance?
    a. An entire journal entry has been omitted from the posting procedure.
    b. The debit portion of an entry is posted as a credit, and the credit portion is posted as a debit.
    c. The debit balance of an account is transferred to the credit column of the trial balance.
    d. A credit entry is entered into the wrong credit account.
    e. An entire transaction is entered in the general journal incorrectly as $127 instead of $172.

15. Owner's Capital appears on which pair of financial statements?
    a. Balance sheet and income statement
    b. Income statement and Statement of Cash Flows
    c. Statement of Retained Earnings and Income Statement
    d. Statement of Owner's Equity and Balance sheet
    e. Statement of Owner's Equity and Statement of Cash Flows

16. Which of the following does *not* result in the recording of an expense?
    a. The expiration of insurance
    b. Payment of an account payable
    c. The recording of wages incurred
    d. The receipt of a utility bill
    e. The purchase of gasoline for a company vehicle

17. Which of the following lists gives the correct sequence of accounting procedures?
    a. Ledger, journal, trial balance, financial statements
    b. Financial statements, journal, ledger, trial balance
    c. Journal, ledger, trial balance, financial statements
    d. Trial balance, financial statements, ledger, journal
    e. Journal, ledger, financial statements, trial balance

ANSWERS TO REVIEW QUIZ

True-False

1. F
2. T
3. F
4. T
5. T
6. T
7. F

Multiple Choice

8. d
9. e
10. e
11. c
12. b
13. a
14. c
15. d
16. b
17. c

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