

## Chapter 1

An Introduction to Accounting

## Section 1: Collecting and Organizing Information

**Accounting** is an information system that reports on the economic activities and financial condition of a business or other organization.

LO 1-1:

Identify the ways accounting benefits society.

## Role of Accounting in Society

How should society allocate its resources? Should we spend more money to harvest food or cure disease?

## Role of Accounting in Society Continued

Should we build computers or cars? Should we invest money in IBM or General Motors?

Accounting provides information that helps answer such questions.

### Market-Based Allocations



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A market is a group of people or entities organized to exchange items of value.

## Market-Based Allocations Continued

# Common terms for the *added value* created in the transformation process:

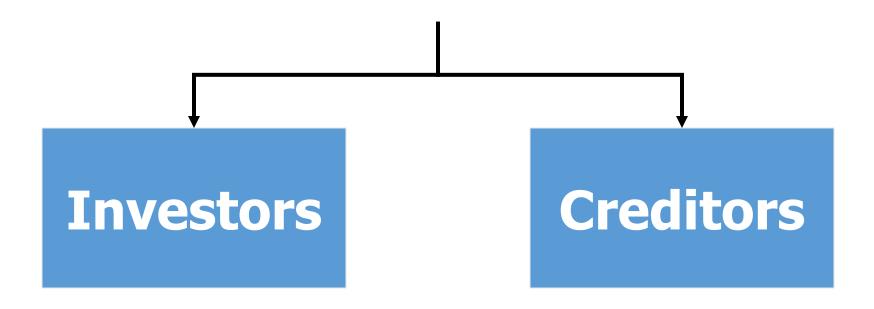




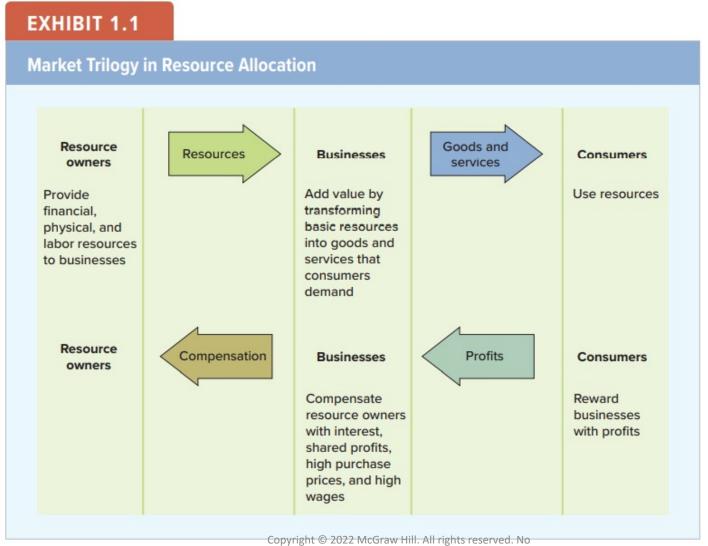


### Financial Resources

## Businesses need financial resources (money) to establish and operate their businesses.



## Market Trilogy in Resource Allocation



## Physical Resources

In their most primitive form, **physical resources** are natural resources.

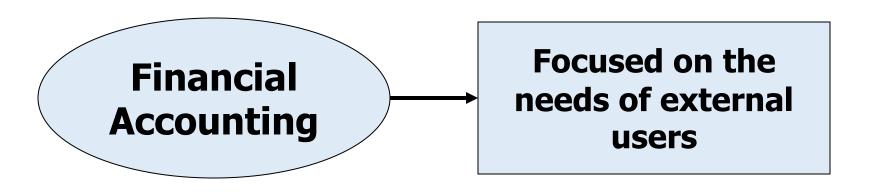
Owners of physical resources seek to sell those resources to profitable businesses which are able to pay higher prices and make repeat purchases.

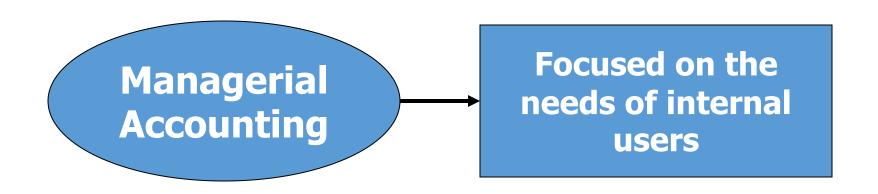
#### Labor Resources

**Labor resources** include both intellectual and physical labor.

Workers seek relationships with businesses that have high earnings potential because these businesses are better able to pay high wages.

## Types of Accounting Information





## Nonbusiness Resource Usage

Not all entities allocate resources based on profitability.

Organizations that are not motivated by profit are called not-for-profit entities.

Governments allocate resources for national defense, to reallocate wealth, or to protect the environment.

Foundations, religious groups, and various benevolent organizations allocate resources based on humanitarian concerns.

## Careers in Accounting

Public Accounting

Certified Public Accountant

Audit services

Tax services

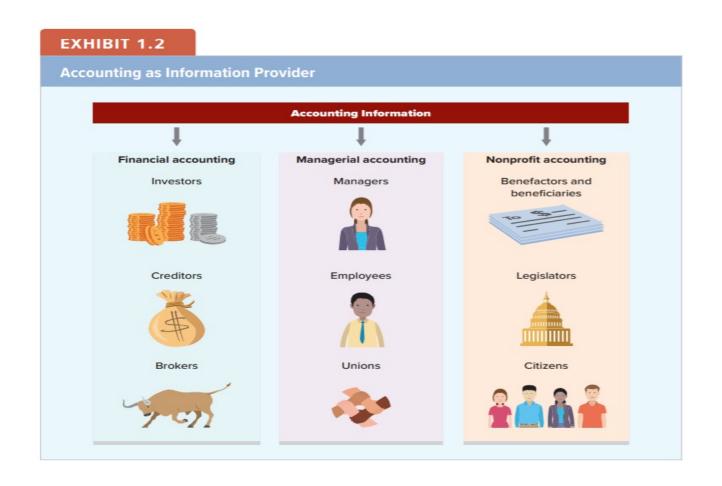
Consulting services

Private Accounting

Certified Management Accountant

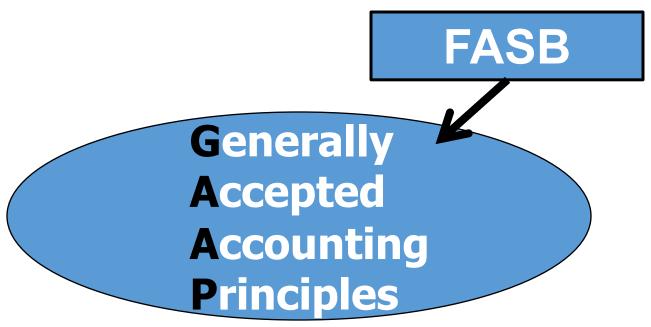
**Certified Internal Auditor** 

## Accounting as Information Provider



## **Accounting Improves Communication**

Accountants establish measurement and reporting rules that businesses use to facilitate communication.



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#### Focus on International Issues

Until recently, each country developed its own unique GAAP. Global companies were required to prepare multiple sets of financial statements.

To address the need for a common set of financial standards, the International Accounting Standards Committee was formed in 1973.

The committee was reorganized as the International Accounting Standards Board (IASB) in 2001.

## LO 1-2:

Identify reporting entities.

## **Reporting Entities**

Financial accounting reports disclose the financial activities of particular individuals or organizations described as reporting entities.

Each entity is treated as a separate reporting unit.

**Businesses** 

**Individuals** 

**Organizations** 

## LO 1-3:

Identify the components of the accounting equation.

## Elements of Financial Statements

- 1. Assets
- 2. Liabilities
- 3. Stockholders' Equity
- 4. Contributed Capital
- 5. Revenue
- 6. Expenses
- 7. Distributions
- 8. Net Income
- 9. Gains
- 10. Losses

The elements represent broad categories. We will discuss elements 1–8 in this chapter. We will save elements 9 and 10 for a later chapter.

## Using Accounts to Gather Information

- Assets cash, equipment, buildings
- 2. Liabilities
- 3. Stockholders' Equity
- 4. Contributed Capital
- 5. Revenue
- 6. Expenses
- 7. Distributions
- 8. Net Income
- 9. Gains
- 10. Losses

Detailed information about elements is maintained in accounts.

Not all business entities use the same accounts or account names.

## The Accounting Equation

The Accounting Equation is composed of three elements: assets, liabilities and stockholders' equity. Stockholders' equity is subdivided into two additional elements called common stock and retained earnings.

Businesses use resources to conduct their operations. The resources a business uses to earn money are called assets.

## Creating an Accounting Equation

## Assets = Claims

Claims on the assets are from three sources:

- 1. Creditors (liabilities)
- 2. Investors (stockholders' equity)
- 3. Operations (profits increase assets)

## Assets = Liabilities + Stockholders' equity

## Creating an Accounting Equation Continued

Commitments made to investors are described in certificates called common stock.

## Assets = Liabilities + Stockholders' equity

Common Stock Retained Earnings

Increases to stockholders' equity from earnings are called retained earnings.

## LO 1-4:

Show how business events affect the accounting equation.

# Recording Business Events Under an Accounting Equation

An accounting event is an economic occurrence that changes an entity's assets, liabilities, or stockholders' equity.

A transaction is a particular kind of event that involves transferring something of value between two entities.

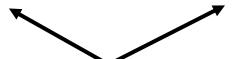
### **Asset Source Transactions**

# Event 1: Rustic Camp Sites (RCS) was formed on January 1, Year 1, when it acquired \$120,000 cash from issuing common stock.

- 1. RCS increases assets (cash).
- 2. RCS increases stockholders' equity (common stock).



Double-Entry Bookkeeping



## **Recorded Twice**

### An Asset Source Transaction

# Event 2: RCS acquired an additional \$400,000 of cash by borrowing from a creditor.

- 1. RCS increases assets (cash).
- 2. RCS increases liabilities (notes payable).

	Accounting Equation						
	Assets = Liab. + Stockholders' Equity						
Event No. 2	Cash + Land = N. Pay. + Com. Stk. + Ret. Earn.						
Acquired cash by issuing note	400,000 + NA + 400,000 + NA + NA						

## **Asset Exchange Transaction**

## **Event 3: RCS paid \$500,000 cash to purchase land.**

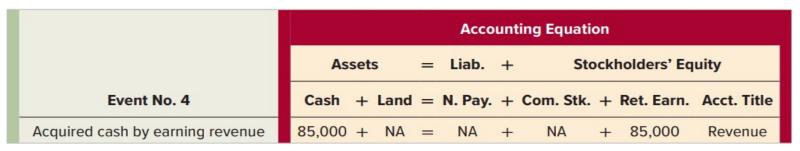
- 1. RCS decreases assets (cash).
- 2. RCS increases assets (land).

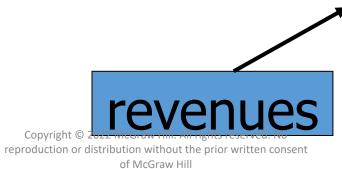
	Accounting Equation								
	Assets			=	Liab.	+ Stockholders' Equity			
Event No. 3	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.
Paid cash to buy land	(500,000)	+	500,000	=	NA	+	NA	+	NA

### **Another Asset Source Transaction**

# Event 4: RCS obtained \$85,000 cash by leasing campsites to customers.

- 1. RCS increases assets (cash).
- 2. RCS increases stockholders' equity (retained earnings).





### **Asset Use Transaction**

# Event 5: RCS paid \$50,000 cash for operating expenses such as salaries, rent, and interest.

- 1. RCS decreases assets (cash).
- 2. RCS decreases stockholders' equity (retained earnings).

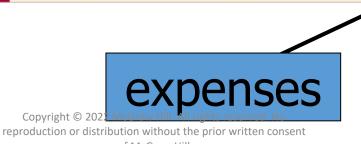
```
Assets = Liab. + Stockholders' Equity

Event No. 5

Cash + Land = N. Pay. + Com. Stk. + Ret. Earn. Acct. Title

Used cash to pay expenses

(50,000) + NA = NA + NA + (50,000) Expense
```



### **Another Asset Use Transaction**

# Event 6: RCS paid \$4,000 in cash dividends to its owners.

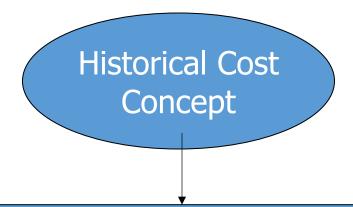
- 1. RCS decreases assets (cash).
- 2. RCS decreases stockholders' equity (retained earnings).

	Accounting Equation										
	As	s	= Liab.		+	- Stoc		holders' Eq	uity		
Event No. 6	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Acct. Title	
Used cash to pay dividends	(4,000)	+	NA	=	NA	+	NA	+	(4,000)	Dividends	



## Changes in Market Value

Event 7: The land that RCS paid \$500,000 to purchase had an appraised market value of \$525,000 on December 31, Year 1.



Requires that most assets be reported at the amount paid for them (their historical cost) regardless of increases in market value.

## Summary of Accounting Events

#### **EXHIBIT 1.3**

Accounting	Accounting Events								
1	RCS issued common stock, acquiring \$120,000 cash from its owners.								
2	RCS borrowed \$400,000 cash.								
3	RCS paid \$500,000 cash to purchase land.								
4	RCS received \$85,000 cash from earning revenue.								
5	RCS paid \$50,000 cash for expenses.								
6	RCS paid dividends of \$4,000 cash to the owners.								
7	The land that RCS paid \$500,000 to purchase had an appraised market value of \$525,000 on December 31, Year 1.								

## Summary of Accounting Events

General Ledger Accounts Organized under the Accounting Equation										
	Assets				Liabilities	s' Equity	Account			
Event No.	Cash	+ Land		=	N. Pay.	+	Com. Stk. +		Ret. Earn.	Titles for RE
Beg. bal.	0		0		0		0		0	
1	120,000						120,000			
2	400,000				400,000					
3	(500,000)		500,000							
4	85,000								85,000	Revenue
5	(50,000)								(50,000)	Expense
6	(4,000)								(4,000)	Dividend
7	NA		NA		NA		NA		NA	
End bal.	51,000	+	500,000	=	400,000	+	120,000	+	31,000	

## LO 1-5:

Interpret information shown in an accounting equation.

# The Left versus the Right Side of the Accounting Equation

Assets are displayed on the left side of the accounting equation.
Assets include cash, but are not always cash.

The right side of the equation is **not** related to the amount of actual cash a company has on hand.

The right side of the accounting equation identifies the sources of the company's assets, **not** their composition.

# Cash and Retained Earnings

While Retained Earnings
does not represent the
amount of cash on hand, it
does limit the amount of
cash that can be used to pay
dividends.

Dividends are distributions of assets generated through earnings

So, both Cash and Retained Earnings are needed to pay cash dividends.

# **Business Liquidations**

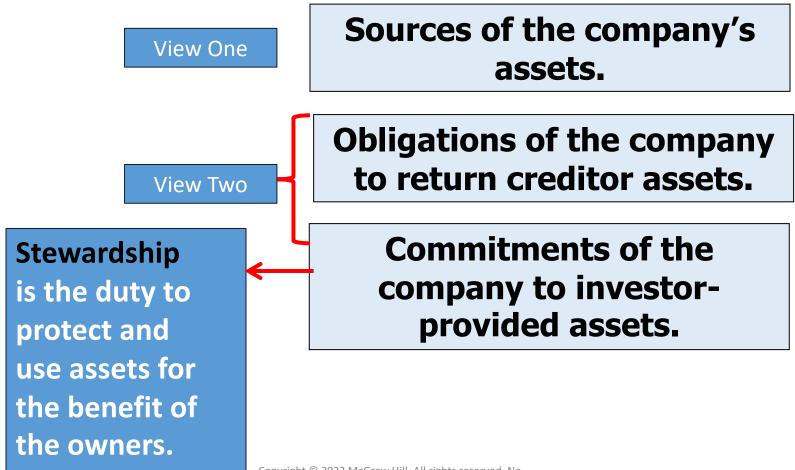
Liquidations can result from net losses or mismanagement of assets.

Creditors have priority and investors receive any residual.

Going Concern

Assumes that a business is able to continue operations into the foreseeable future.

# Two Views of the Right Side of the Accounting Equation



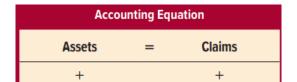
LO 1-6:

Classify business events as asset source, use, or exchange transactions.

# Recap: Types of Transactions

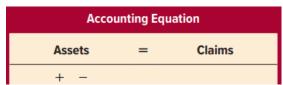
# The described transactions have been classified into one of three categories:

### **Asset Source**



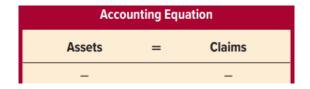
Increase total assets, increase total claims

## **Asset Exchange**



Increase one asset, decrease another asset

### Asset Use



Decrease total assets, decrease total claims

# Section 2: Reporting Information

Accounting information is normally presented to external users in four general-purpose financial statements.

The information in the ledger accounts is used to prepare these financial statements.

The next section explains how the information in the accounts is presented in financial statements.

### LO 1-7:

Prepare an income statement, a statement of changes in stockholders' equity, and a balance sheet.

# Income Statement and the Matching

Concent

#### **RUSTIC CAMP SITES**

Income Statement
For the Year Ended December 31, Year 1

Rental revenue (asset increases)

Operating expenses (asset decreases)

Net income

\$85,000

(50,000)

\$35,000

Matching Concept

Revenues exceeded expenses.

If expenses exceed revenues,
the entity will report a **net loss**.

Revenues (benefits) are matched to expenses (sacrifices).

Income is measured for a span of time called the accounting period.

## Statement of Changes in Stockholders' Equity

RUSTIC CAMP SITES  Statement of Changes in Stockholders' Equity  For the Year Ended December 31, Year 1							
Beginning common stock Plus: common stock issued Ending common stock Beginning retained earnings Plus: Net income Less: Dividends	\$ 0 120,000 \$120,000 0 35,000 (4,000)						
Ending retained earnings Total stockholders' equity	31,000 \$151,000						

## **Balance Sheet**

RUSTIC CAMP SIT  Balance Sheet  As of December 31, Ye		
Assets Cash Land Total assets	\$ 51,000 500,000	<u>\$551,000</u>
Liabilities Notes payable Stockholders' equity Common stock	\$120,000 -	\$400,000
Retained earnings Total stockholders' equity Total liabilities and stockholders' equity	31,000 -	151,000 \$551,000

LO 1-8:

Prepare a statement of cash flows.

# Statement of Cash Flows for Rustic Camp Sites

RUSTIC CAMP SITES Statement of Cash Flows For the Year Ended December 31, Year 1									
Cash flows from operating activities: Cash receipts from revenue	\$ 85,000								
Cash payments for expenses	(50,000)								
Net cash flow from operating activities		\$ 35,000							
Cash flows from investing activities:									
Cash payments to purchase land		(500,000)							
Cash flows from financing activities:									
Cash receipts from borrowing funds	400,000								
Cash receipts from issuing common stock	120,000								
Cash payments for dividends	(4,000)								
Net cash flow from financing activities		516,000							
Net increase in cash		51,000							
Plus: beginning cash balance		0							
Ending cash balance		\$ 51,000							

### Statement of Cash Flows

#### **EXHIBIT 1.5**

#### Classification Scheme for Statement of Cash Flows

#### Cash flows from operating activities:

Cash receipts (inflows) from customers

Cash payments (outflows) to suppliers

#### Cash flows from investing activities:

Cash receipts (inflows) from the sale of long-term assets

Cash payments (outflows) for the purchase of long-term assets

#### Cash flows from financing activities:

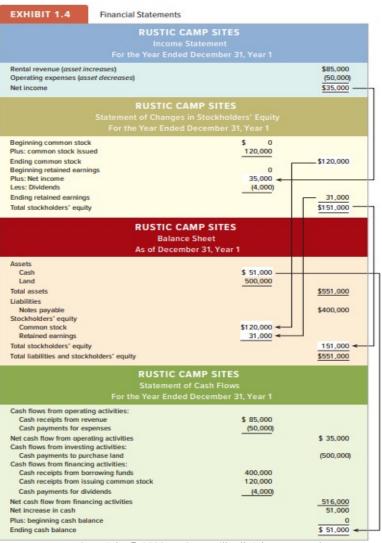
Cash receipts (inflows) from borrowing funds

Cash receipts (inflows) from issuing common stock

Cash payments (outflows) to repay borrowed funds

Cash payments (outflows) for dividends

### **Financial Statements**



LO 1-9:

Close revenue, expense, and dividend accounts.

# The Closing Process

The process of transferring information from the revenue, expense, and dividend (temporary) accounts to the Retained Earnings account is called closing.

Since the Retained Earnings account carries forward from one accounting period to the next, it is considered a **permanent** account.

LO 1-10:

Record business events using a horizontal financial statements model.

# Accounting Events for RCS During Year 1

- RCS acquired \$120,000 cash from the issuance of common stock.
- RCS borrowed \$400,000 cash.
- RCS paid \$500,000 cash to purchase land.
- RCS received \$85,000 cash from earning revenue.
- RCS paid \$50,000 cash for expenses.
- RCS paid \$4,000 of cash dividends to the owners.
- The market value of the land owned by RCS was appraised at \$525,000 on December 31, Year 1.

## Horizontal Financial Statements Model

				ı	Balance Sh	eet					Inc	ome State	mer	nt	Statemer	nt of
Event	A	sset	5	=	Liab.	+	Stockho	oldei	rs' Equity						Cash Flo	
No.	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	_	Exp.	=	Net Inc.		
Beg. bal.	0	+	0	=	0	+	0	+	0	0	_	0	=	0	NA	
1.	120,000	+	NA	=	NA	+	120,000	+	NA	NA	_	NA	=	NA	120,000	FΑ
2.	400,000	+	NA	=	400,000	+	NA	+	NA	NA	-	NA	=	NA	400,000	FA
3.	(500,000)	+	500,000	=	NA	+	NA	+	NA	NA	_	NA	=	NA	(500,000)	IA
4.	85,000	+	NA	=	NA	+	NA	+	85,000	85,000	_	NA	=	85,000	85,000	OA
5.	(50,000)	+	NA	=	NA	+	NA	+	(50,000)	NA	_	50,000	=	(50,000)	(50,000)	OA
6.	(4,000)	+	NA	=	NA	+	NA	+	(4,000)	NA	_	NA	=	NA	(4,000)	FA
7.	NA	+	NA	=	NA	+	NA	+	NA	NA	_	NA	=	NA	NA	
Totals	51,000	+	500,000	=	400,000	+	120,000	+	31,000	85,000	-	50,000	=	35,000	51,000	NC

# Real-World Financial Reporting

EXHIBIT 1.8	HIBIT 1.8 Real-World Financial Reporting								
MERCK & CO., INC. AND SUBSIDIARIES  Consolidated Statement of Income (partial)  Years Ended December 31  (\$ in millions except per share amounts)									
		2018	2017	2016					
Sales Costs, expenses, and of Cost of sales Selling, general and Research and develo	administrative	\$42,294 13,509 10,102 9,752	\$40,122 12,912 10,074 10,339	\$39,807 14,030 10,017 10,261					
Restructuring costs Other (income) expen		632 (402) 33,593	776 (500) 33,601	651 189 35,148					
Income before taxes Taxes on income		8,701 	6,521 4,103	4,659 718					
Net income Less: Net income attribut	table to noncontrolling interests	6,193 (27)	2,418 <u>24</u>	3,941 21					
Net income attributable	to Merck & Co., Inc.	\$ 6,220	\$ 2,394	\$ 3,920					

# **Annual Report**

#### **Consists of:**

- (1) Financial Statements
- (2) Notes
- (3) Auditors' Report -Chapter 6
- (4) Management's Discussion and Analysis (MD&A)

The U.S. Securities and Exchange Commission (SEC) requires publicly traded corporations to file a 10-K report, which contains more detailed financial information, and frequently substitutes for the annual report.

# Special Terms in Real-World Reports



Andrew Resek/McGraw Hill

- The financial statements of realworld companies include numerous items relating to advanced topics that are not covered in introductory accounting textbooks.
- However, we encourage you to look for annual reports in the library, from your employer, or on the Internet. Look for links labeled "about the company" or "investor relations."

The best way to learn accounting is to use it!

# End of Chapter 1