

Accounting and the Business Environment 1



Coffee, Anyone?

Aiden Jackson stared at the list the banker had given him during their meeting. *Business plan, cash flow projections, financial statements, tax returns.* Aiden had visited with the banker because he had a dream of opening a coffee shop near campus. He knew there was a need; students were always looking for a place to study and visit with their friends. He also had the experience. He had worked for the past three years as a manager of a coffee shop in a neighboring town. Aiden needed one thing, though—money. He had saved a small amount of money from his job and received several contributions from family and friends, but he still didn't have enough to

open the business. He had decided the best option was to get a loan from his bank. After the meeting, Aiden felt overwhelmed and unsure of the future of his business.

You might think that Aiden was facing an impossible situation, but you'd be wrong. Almost every new business faces a similar situation. The owner starts with an inspiration, and then he or she needs to provide enough continuous cash flow to build the business. In addition, the owner has to make decisions such as: *Should we expand to another location? Do we have enough money to purchase a new coffee roaster? How do I know if the business made a profit?*

So how does Aiden get started? Keep reading. That's what accounting teaches you.



Why Study Accounting?

The situation that Aiden faced is similar to the situations faced in the founding of most businesses. **Starbucks Corporation**, for example, first opened its doors in Seattle, Washington, in 1971. Three partners, Jerry Baldwin, Zev Siegl, and Gordon Bowker, were inspired by a dream of selling high-quality coffee. We know their dream was successful because Starbucks currently has more than 22,000 stores in 67 countries. How did Starbucks grow from a small one-store shop to what it is today? The partners understood accounting—the language of business. They understood how to measure the activities of the business, process that information into reports (financial statements), and then use those reports to make business decisions. Your knowledge of accounting will help you better understand businesses. It will make you a better business owner, employee, or investor.





Chapter 1 Learning Objectives

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

WHY IS ACCOUNTING IMPORTANT?

Learning Objective 1

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

Accounting

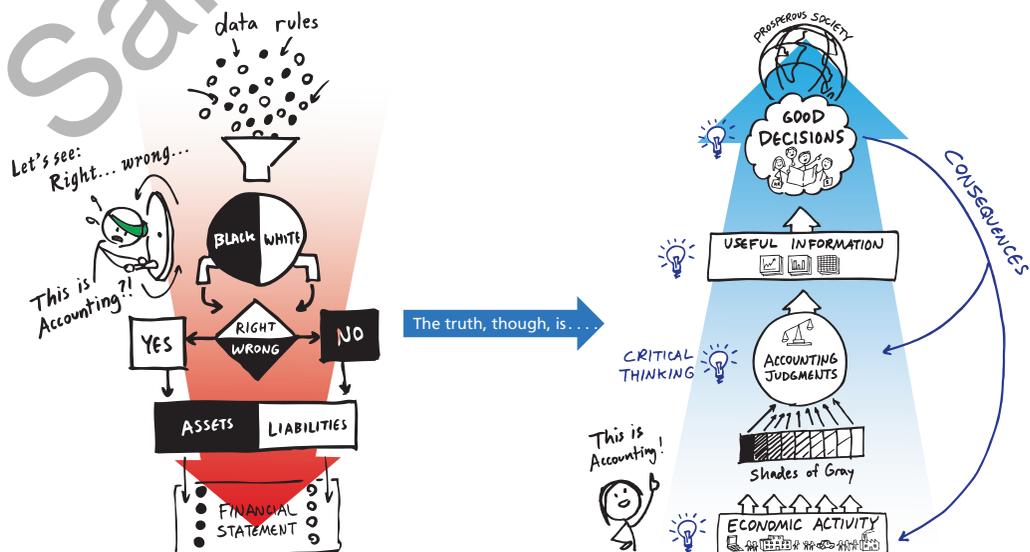
The information system that measures business activities, processes the information into reports, and communicates the results to decision makers.

You've heard the term *accounting*, but what exactly is it? **Accounting** is the information system that measures business activities, processes the information into reports, and communicates the results to decision makers. Accounting is the language of business. The better you understand the language of business, the better you can manage your own business, be a valuable employee, or make wise investments.

We tend to think of accountants as boring and dry. However, accounting is much more than simple recordkeeping or bookkeeping. Today's accountants participate in a broad range of activities such as the investigation of financial evidence, the development of computer programs to process accounting information, and the communication of financial results to interested parties. The knowledge of accounting is used every day to help make business decisions.

The Pathways Vision Model (see Exhibit F:1-1), created by the Pathways Commission, provides a visual interpretation of what accountants really do. Accounting starts with

Exhibit F:1-1 Pathways Vision Model



We tend to think of accountants as boring and dry.

Accountants are instrumental in helping to create a prosperous society.



economic activities that accountants review and evaluate using critical thinking and judgment to create useful information that helps individuals make good decisions. The model emphasizes that good decisions have an impact on accounting judgments and economic activity, thus creating a circular flow of cause and effect. Accountants are more than boring, tedious number crunchers. Instead, accountants play a critical role in supporting a prosperous society.

Decision Makers: The Users of Accounting Information

We can divide accounting into two major fields: financial accounting and managerial accounting. **Financial accounting** provides information for external decision makers, such as outside investors, lenders, customers, and the federal government. **Managerial accounting** focuses on information for internal decision makers, such as the company's managers and employees.

Exhibit F:1-2 illustrates the difference between financial accounting and managerial accounting. Regardless of whether they are external or internal to the company, all decision makers need information to make the best choices. The bigger the decision, the more information decision makers need. Let's look at some ways in which various people use accounting information to make important decisions.

Financial Accounting

The field of accounting that focuses on providing information for external decision makers.

Managerial Accounting

The field of accounting that focuses on providing information for internal decision makers.

Exhibit F:1-2 | Decision Making: Financial Versus Managerial Accounting

Financial Accounting	Managerial Accounting
	
<p>External Decision Makers:</p> <p>Should I invest in the business? Is the business profitable? Should we lend money to the business? Can the business pay us back?</p>	<p>Internal Decision Makers:</p> <p>How much money should the business budget for production? Should the business expand to a new location? How do actual costs compare to budgeted costs?</p>

IFRS

Accounting is alive! As businesses evolve and the types of business transactions change, so must the language of business. The most significant changes in the business world in the last decade have been the huge increases in international commerce. Because more business is conducted internationally, decision makers are looking for an international accounting language.

Look for more information about International Financial Reporting Standards (IFRS) anywhere you see the IFRS heading.

Individuals

How much cash do you have? How much do you need to save each month to retire at a certain age or pay for your children's college education? Accounting can help you answer questions like these. By using accounting information, you can manage your money, evaluate a new job, and better decide whether you can afford to buy a new computer. Businesses need accounting information to make similar decisions.

Businesses

Business owners use accounting information to set goals, measure progress toward those goals, and make adjustments when needed. The financial statements give owners the information they need to help make those decisions. Financial statements are helpful when, for example, a business owner wants to know whether his or her business has enough cash to purchase another computer.



Investors

Outside investors who have some ownership interest often provide the money to get a business going. Suppose you're considering investing in a business. How would you decide whether it is a good investment? In making this decision, you might try to predict the amount of income you would earn on the investment. Also, after making an investment, investors can use a company's financial statements to analyze how their investment is performing.

You might have the opportunity to invest in the stock market through your company's retirement plan. Which investments should you pick? Understanding a company's financial statements will help you decide. You can view the financial statements of large companies that report to the Securities and Exchange Commission (SEC) by logging on to <http://www.finance.yahoo.com>, <http://www.google.com/finance>, or the SEC's EDGAR database (<http://www.sec.gov/edgar.shtml>).

Creditors

Creditor
Any person or business to whom a business owes money.

Any person or business to whom a business owes money is a **creditor**. Before extending credit to a business, a creditor evaluates the company's ability to make the payments by reviewing its financial statements. Creditors follow the same process when you need to borrow money for a new car or a house. The creditor reviews accounting data to determine your ability to make the loan payments. What does your financial position tell the creditor about your ability to repay the loan? Are you a good risk for the bank?

Taxing Authorities

Local, state, and federal governments levy taxes. Income tax is calculated using accounting information. Good accounting records can help individuals and businesses take advantage of lawful deductions. Without good records, the Internal Revenue Service (IRS) can disallow tax deductions, resulting in a higher tax bill plus interest and penalties.

Accounting Matters

Certified Public Accountants (CPAs)
Licensed professional accountants who serve the general public.

Chartered Global Management Accountant (CGMA)
Professional accountant with advanced knowledge in finance, operations, strategy, and management.

What do businesses such as Amazon.com, Walmart, or even your local sandwich shop across from campus have in common? They all rely upon accounting information to make business decisions. Even if you don't plan on majoring in accounting, the knowledge of accounting helps all businesses plan for the future and evaluate past performance. The skills you learn in this class will help you be a better business professional. Businesses can't function, though, without accountants. That is why a degree in accounting opens so many doors upon graduation. A bachelor's degree in accounting could lead you to several different accounting careers.

You've probably heard of a CPA before. **Certified Public Accountants**, or **CPAs**, are licensed professional accountants who serve the general public. CPAs work for public accounting firms, businesses, government entities, or educational institutions. What does it take to be a CPA? Although requirements vary between states, to be certified in a profession, one must meet the educational and/or experience requirements *and* pass a qualifying exam. Accountants can also obtain a **Chartered Global Management Accountant (CGMA)** designation. This distinguishes accountants who have advanced knowledge in finance, operations, strategy, and management. **The American Institute of Certified Public Accountants (AICPA) Web site (<http://www.thiswaytocpa.com>) contains a wealth of information about becoming a CPA or CGMA, career opportunities, and exam requirements.**

What if I want more information about becoming a CPA or CMA?



Certified Management Accountants (CMAs)
Professional accountants who specialize in accounting and financial management knowledge.

Certified Management Accountants, or **CMAs**, are certified professionals who specialize in accounting and financial management knowledge. Generally, CMAs work for a single company. **You can find information about becoming a CMA, how a CMA differs from a CPA, and why employers are recognizing the CMA certification on the Institute of Management Accountants (IMA) Web site (<http://www.imanet.org>).**



Another specialization in accounting is a **Certified Financial Planner**, or **CFP**. CFPs work with individuals to help them budget, plan for retirement, save for education, and manage their finances. Individuals who want to obtain their CFP must have the four E's: education, examination, experience, and ethics. You can find out more about becoming a CFP on the following Web site: <https://www.cfp.net/home>.

Studying accounting and becoming certified professionally can lead to a financially secure job. It's worth it for an accountant to spend the time and energy to get certified—certified accountants generally make 10–15% more than their noncertified colleagues when they enter the workforce. According to Robert Half's *2019 Salary Guide*, the top in-demand positions that rely on accounting skills are controllers, financial analysts, tax accountants, auditors, cost accountants, accounting clerks/bookkeepers, and business systems analysts. How much do these types of accountants make? Exhibit F:1-3 provides a snapshot of the earning potential for key positions.

Certified Financial Planner (CFP)

Certified professional who specializes in budgeting, planning for retirement, and managing finances.

Exhibit F:1-3 | Comparison of Accounting Positions

Position	Job Description	Salary Range
Controllers	Compile financial statements, interact with auditors, and oversee regulatory reporting.	\$92,000–\$207,750
Financial analysts	Review financial data and help to explain the story behind the numbers.	\$42,500–\$201,250
Business systems analysts	Use accounting knowledge to create computer systems.	\$42,500–\$185,000
Tax accountants	Help companies navigate tax laws.	\$39,500–\$212,250
Auditors	Perform reviews of companies to ensure compliance to rules and regulations.	\$39,500–\$208,750
Cost accountants	Typically work in a manufacturing business. Help analyze accounting data.	\$42,000–\$143,750
Accounting clerks/ Bookkeepers	Record financial transactions and help prepare financial records.	\$28,250–\$65,750

Based on Robert Half's 2019 Salary Guide <https://www.roberthalf.com/salary-guide>

Accountants generally work either in corporate or industry accounting, public accounting, financial services, or governmental accounting. Corporate or industry accounting professionals are in demand in every sector of the business community, including manufacturing, construction, and healthcare. As the population of the world continues to age, accountants are in high demand in healthcare organizations to address billing and collections, data and business analysis, and changing revenue models. Corporate/industry accountants typically work for a single company, such as Amazon.com, Walmart, Dell, or UnitedHealthcare. Public accounting involves services such as auditing, tax preparation, and consulting. Well-known public accounting firms include Ernst & Young, Deloitte, PricewaterhouseCoopers (PwC), and KPMG. Accountants also work in financial services organizations such as banks. Other accountants work for federal, state, or local governments. Sought-after skills of accountants include being licensed or certified (e.g., CPA or CMA), data analytics, Excel, a strong work ethic, effective verbal and written communication, and leadership. Wherever accountants work, demand for their services is high. According to the U.S. Bureau of Labor Statistics, employment of accountants and auditors is expected to grow 10% (faster than average) from 2016–2026.



Data Analytics in Accounting

Today's accountants need to know more than just accounting knowledge. They also need to have an understanding of how technology is used to process financial information. Accounting and finance individuals actively work with information technology teams to develop accounting systems. Artificial intelligence, cloud-based systems, and robotic process automation are all changing the way companies handle financial information. Ideal accounting employees have knowledge in both accounting and technology.

Try It!

Match the accounting terminology to the definitions.

- | | |
|-------------------------------------|---|
| 1. Certified management accountants | a. information system that measures business activities, processes that information into reports, and communicates the results to decision makers |
| 2. Accounting | b. professional accountants who serve the general public |
| 3. Managerial accounting | c. person or business to whom a business owes money |
| 4. Certified public accountants | d. field of accounting that focuses on providing information for internal decision makers |
| 5. Financial accounting | e. professionals who work for a single company |
| 6. Creditor | f. field of accounting that focuses on providing information for external decision makers |

Check your answers online in MyLab Accounting or at <https://www.pearsonglobaleditions.com/Horngren>.

For more practice, see Short Exercise S-F:1-1. [MyLab Accounting](#)

WHAT ARE THE ORGANIZATIONS AND RULES THAT GOVERN ACCOUNTING?

Learning Objective 2

Describe the organizations and rules that govern accounting

All professions have regulations. Let's look at the organizations and rules that govern the accounting profession.

Governing Organizations

Financial Accounting Standards Board (FASB)

The private organization that oversees the creation and governance of accounting standards in the United States.

Securities and Exchange Commission (SEC)

U.S. governmental agency that oversees the U.S. financial markets.

Generally Accepted Accounting Principles (GAAP)

Accounting guidelines, currently formulated by the Financial Accounting Standards Board (FASB); the main U.S. accounting rule book.

In the United States, the **Financial Accounting Standards Board (FASB)**, a privately funded organization, oversees the creation and governance of accounting standards. The FASB works with governmental regulatory agencies like the **Securities and Exchange Commission (SEC)**. The SEC is the U.S. governmental agency that oversees the U.S. financial markets. It also oversees those organizations that set standards (like the FASB). The FASB also works with congressionally created groups like the Public Company Accounting Oversight Board (PCAOB) and private groups like the American Institute of CPAs (AICPA), Institute of Management Accountants (IMA), and International Accounting Standards Board (IASB).

Generally Accepted Accounting Principles

The guidelines for accounting information are called **Generally Accepted Accounting Principles (GAAP)**. GAAP is the main U.S. accounting rule book and is currently created and governed by the FASB. In order to use and prepare financial statements, it's important that we understand GAAP. GAAP rests on a conceptual framework that identifies the



objectives, characteristics, elements, and implementation of financial statements and creates the acceptable accounting practices. The primary objective of financial reporting is to provide information useful for making investment and lending decisions. To be useful, information must be relevant and have **faithful representation**.¹ Relevant information allows users of the information to make a decision. Information that is faithfully representative is complete, neutral, and free from material error. These basic accounting assumptions and principles are part of the foundation for the financial reports that companies present.

The Economic Entity Assumption

The most basic concept in accounting is that of the **economic entity assumption**. An economic (business) entity is an organization that stands apart as a separate economic unit. We draw boundaries around each entity to keep its affairs distinct from those of other entities. An entity refers to one business, separate from its owners.

A business can be organized as a sole proprietorship, partnership, corporation, or limited-liability company (LLC). Exhibit F:1-4 summarizes the similarities and differences among the four types of business organizations.

Distinguishing Characteristics and Organization of a Corporation

In this book, we spend most of our time studying accounting for corporations. There are several features that distinguish a corporation from other types of business organizations. Let's look at them now.

Separate Legal Entity A corporation is a business entity formed under state law. The state grants a charter (also called *articles of incorporation*), which is the document that gives the state's permission to form a corporation. This is called an *authorization* because the state "authorizes" or approves the establishment of the corporate entity.

Faithful Representation

Providing information that is complete, neutral, and free from error.

Economic Entity Assumption

An organization that stands apart as a separate economic unit.

Sole Proprietorship

A business with a single owner.

Partnership

A business with two or more owners and not organized as a corporation.

Corporation

A business organized under state law that is a separate legal entity.

Limited-Liability Company (LLC)

A company in which each member is only liable for his or her own actions.

Exhibit F:1-4 | Business Organizations

	Sole Proprietorship	Partnership	Corporation	Limited-Liability Company (LLC)
Definition	A business with a single owner	A business with two or more owners and not organized as a corporation	A business organized under state law that is a separate legal entity	A company in which each member is only liable for his or her own actions
Number of owners	One (called the <i>proprietor</i>)	Two or more (called <i>partners</i>)	One or more (called <i>stockholders</i>)	One or more (called <i>members or partners</i>)
Life of the organization	Terminates at owner's choice or death	Terminates at a partner's choice or death	Indefinite	Indefinite
Personal liability of the owner(s) for the business's debts	The owner is personally liable.	The partners are personally liable.	Stockholders are not personally liable.	Members are not personally liable.
Taxation	Not separate taxable entities. The owner pays tax on the proprietorship's earnings.	Partnership is not taxed. Instead partners pay tax on their share of the earnings.	Separate taxable entity. Corporation pays tax.	LLC is not taxed. Instead members pay tax on their share of earnings.
Type of business	Small businesses	Professional organizations of physicians, attorneys, and accountants	From small business to large multinational businesses	An alternative to the partnership

¹ This wording was changed from relevant and reliable by the *Statement of Financial Accounting Concepts No. 8*.



Stockholder

A person who owns stock in a corporation.

A corporation is a distinct entity from a legal perspective. It is an entity that exists apart from its owners, who are called the **stockholders** or *shareholders*. However, the corporation has many of the rights that a person has. For example, a corporation may buy, own, and sell property; enter into contracts; sue; and be sued. Items that the business owns (its assets) and those items that the business has to pay later (its liabilities) belong to the corporation and not to the individual stockholders.

The ownership interest of a corporation is divided into shares of stock. A person becomes a stockholder by purchasing the stock of the corporation. The corporate charter specifies how much stock the corporation is authorized to issue (sell) to the public. Due to this fact, it is usually easier for corporations to raise capital.

Continuous Life and Transferability of Ownership Stockholders may transfer stock as they wish—by selling or trading the stock to another person, giving the stock away, bequeathing it in a will, or disposing of the stock in any other way. Because corporations have continuous lives regardless of changes in the ownership of their stock, the transfer of the stock has no effect on the continuity of the corporation. Sole proprietorships and partnerships, in contrast, end when their ownership changes for any reason. A corporation's life is not dependent on a specific individual's ownership.

No Mutual Agency No mutual agency means that the stockholder of a corporation cannot commit the corporation to a contract unless that stockholder is acting in a different role, such as an officer in the business. Mutual agency of the owners is not present in a corporation as it is in a partnership.

Limited Liability of Stockholders A stockholder has limited liability for the corporation's debts. The most that stockholders can lose is the amount they originally paid for the stock. (Depending on state law, this limited liability would also apply to a limited-liability company member; however, conversely, sole proprietors and partners are personally liable for the debts of their businesses.)

The combination of limited liability and no mutual agency means that persons can invest unlimited amounts in a corporation with only the fear of losing whatever amount the individual has invested if the business fails. This attractive feature enables a corporation to raise more money than proprietorships and partnerships.

Separation of Ownership and Management Stockholders own the business, but a board of directors—elected by the stockholders—appoints corporate officers to manage the business. Thus, stockholders do not have to disrupt their personal affairs to manage the business.

This separation between stockholders (owners of the corporation) and management may create problems. Corporate officers may decide to run the business for their own benefit rather than for the benefit of the company. Stockholders may find it difficult to lodge an effective protest against management because of the distance between them and the top managers.

Corporate Taxation Corporations are separate taxable entities. They pay a variety of taxes not paid by sole proprietorships or partnerships. Depending on the state in which the organization incorporated and the state(s) in which the corporation operates, the taxes could include one or both of the following:

- *Federal and state income taxes:* Corporate earnings are subject to double taxation. First, corporations pay their own income tax on corporate income. Then, the stockholders pay personal income tax on the dividends that they receive from corporations. This is different from sole proprietorships and partnerships, which pay no business income tax. Instead, the tax falls solely on the individual owners.



- *Annual franchise tax levied by the state:* The franchise tax is paid to keep the corporation charter in force and enables the corporation to continue in business.

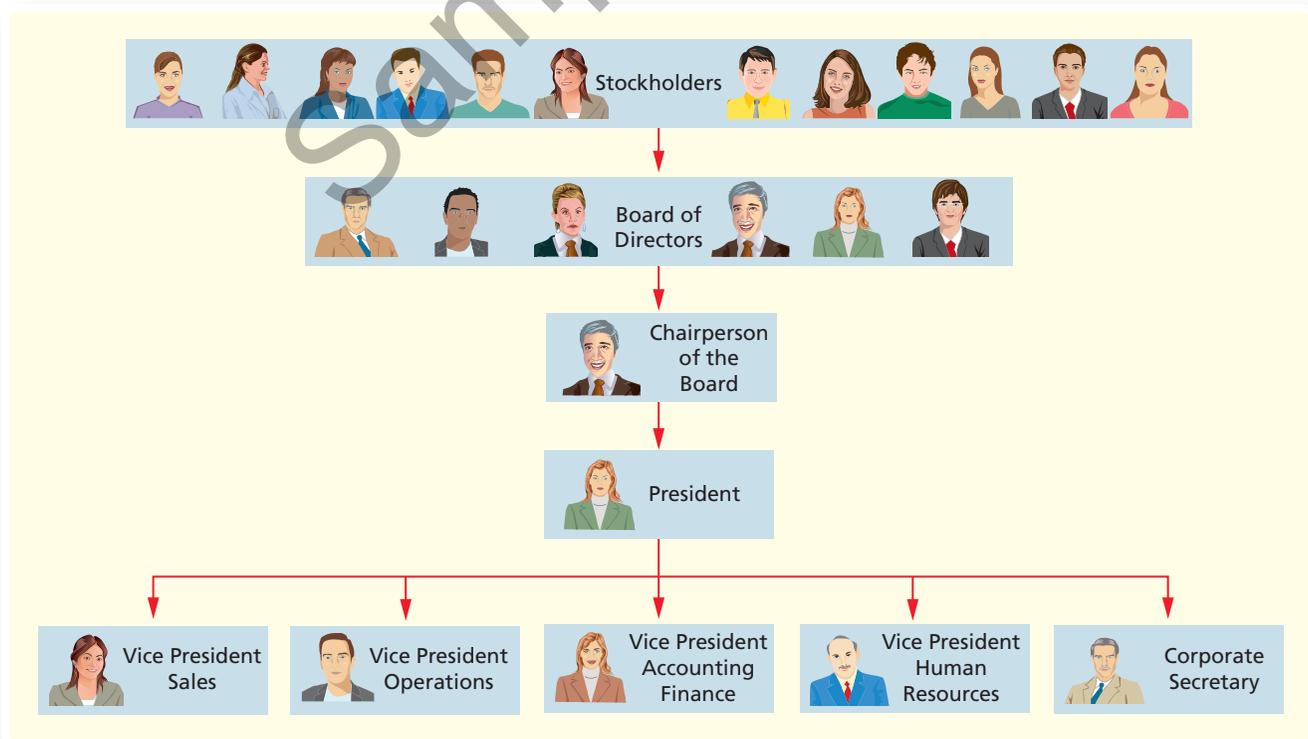
Government Regulation To protect persons who loan money to a corporation or who invest in its stock, states monitor the actions of corporations. Corporations are subjected to more governmental regulation than other forms of business, which is a disadvantage for corporations and can be expensive.

Organization of a Corporation As noted earlier, creation of a corporation begins when its organizers, called the *incorporators*, obtain a charter from the state. The charter includes the authorization for the corporation to issue a certain number of shares of stock, which represent the ownership in the corporation. The incorporators pay fees, sign the charter, and file the required documents with the state. Once the first share of stock is issued, the corporation comes into existence. The incorporators agree to a set of bylaws, which act as the constitution for governing the corporation. Bylaws are the rule book that guides the corporation.

The ultimate control of the corporation rests with the stockholders, who normally receive one vote for each share of stock they own. The stockholders elect the members of the board of directors, which sets policy for the corporation and appoints the officers. The board elects a chairperson, who usually is the most powerful person in the corporation. The board also designates the president, who as chief executive officer manages day-to-day operations. Most corporations also have vice presidents in charge of sales, operations, accounting and finance, and other key areas. Exhibit F:1-5 shows the authority structure in a corporation.

In order to demonstrate the economic entity assumption and several other concepts in this chapter, we will use a fictitious corporation—Smart Touch Learning—an e-learning business that specializes in providing online courses in accounting, economics, marketing, and management. This fictitious business will be used often throughout the book.

Exhibit F:1-5 | Structure of a Corporation





Assume Sheena Bright started the business by organizing it as a corporation. She contributed cash of \$30,000 in exchange for stock of \$30,000. Following the economic entity assumption, the \$30,000 is recorded separately from Sheena's personal assets, such as her clothing and car. To mix the \$30,000 of business cash with Sheena's personal assets would make it difficult to measure the success or failure of Smart Touch Learning. The economic entity assumption requires that each entity be separate from other businesses and from the owners.

The Cost Principle

Cost Principle

A principle that states that acquired assets and services should be recorded at their actual cost.

The **cost principle** states that acquired assets and services should be recorded at their actual cost (also called *historical cost*). The cost principle means we record a transaction at the amount shown on the receipt—the actual amount paid. Even though the purchaser may believe the price is a bargain, the item is recorded at the price actually paid and not at the “expected” cost. For example, assume our fictitious company Smart Touch Learning purchased land for \$20,000. The business might believe the land is instead worth \$25,000. The cost principle requires that Smart Touch Learning record the land at \$20,000, not \$25,000.

The cost principle also holds that the accounting records should continue reporting the historical cost of an asset over its useful life. Why? Because cost is a reliable measure. Suppose Smart Touch Learning holds the land for six months. During that time land prices rise, and the land could be sold for \$30,000. Should its accounting value—the figure on the books—be the actual cost of \$20,000 or the current market value of \$30,000? According to the cost principle, the accounting value of the land would remain at the actual cost of \$20,000.

The Going Concern Assumption

Going Concern Assumption

Assumes that the entity will remain in operation for the foreseeable future.

Another reason for measuring assets at historical cost is the **going concern assumption**. This assumes that the entity will remain in operation for the foreseeable future. Under the going concern assumption, accountants assume that the business will remain in operation long enough to use existing resources for their intended purpose.

The Monetary Unit Assumption

Monetary Unit Assumption

The assumption that requires the items on the financial statements to be measured in terms of a monetary unit.

In the United States, we record transactions in dollars because the dollar is the medium of exchange. The value of a dollar changes over time, and a rise in the price level is called *inflation*. During periods of inflation, a dollar will purchase less. But accountants assume that the dollar's purchasing power is stable. This is the basis of the **monetary unit assumption**, which requires that the items on the financial statements be measured in terms of a monetary unit.

International Financial Reporting Standards

The concepts and principles that we have discussed so far apply to businesses that follow U.S. GAAP and are traded on a U.S. stock exchange, such as the New York Stock Exchange. The SEC requires that U.S. businesses follow U.S. GAAP. Companies who are incorporated in or do significant business in another country might be required to publish financial statements using **International Financial Reporting Standards (IFRS)**, which are published by the **International Accounting Standards Board (IASB)**. IFRS is a set of global accounting standards that are used by more than 166 nations/jurisdictions. They are generally less specific and based more on principle than U.S. GAAP. IFRS leaves more room for professional judgment. For example, unlike U.S. GAAP, IFRS allows periodic revaluation of certain assets and liabilities to restate them to market value, rather than keeping them at historical cost. At one point in time it was thought that the SEC would endorse IFRS. However, the SEC has backed away from this strategy and is currently considering whether a single set of global accounting standards is achievable.

International Financial Reporting Standards (IFRS)

A set of global accounting guidelines, formulated by the International Accounting Standards Board (IASB).

International Accounting Standards Board (IASB)

The private organization that oversees the creation and governance of International Financial Reporting Standards (IFRS).



Ethics in Accounting and Business

Ethical considerations affect accounting. Investors and creditors need relevant and faithfully representative information about a company that they are investing in or lending money to. Companies want to be profitable and financially strong to attract investors and attempt to present their financial statements in a manner that portrays the business in the best possible way. Sometimes these two opposing viewpoints can cause conflicts of interest. For example, imagine a company that is facing a potential million-dollar lawsuit due to a defective product. The company might not want to share this information with investors because it would potentially hurt the business's profitability. On the other hand, investors would want to know about the pending lawsuit so that they could make an informed decision about investing in the business. To handle these conflicts of interest and to provide reliable information, the SEC requires publicly held companies to have their financial statements audited by independent accountants. An **audit** is an examination of a company's financial statements and records. The independent accountants then issue an opinion that states whether the financial statements give a fair picture of the company's financial situation.

The vast majority of accountants do their jobs professionally and ethically, but we often don't hear about them. Unfortunately, only those who cheat make the headlines. In recent years, we have seen many accounting scandals.

In response to the Enron and WorldCom reporting scandals, the U.S. government took swift action. It passed the **Sarbanes-Oxley Act (SOX)**, intended to curb financial scandals. SOX requires management to review internal control and take responsibility for the accuracy and completeness of their financial reports. In addition, SOX made it a criminal offense to falsify financial statements. The Sarbanes-Oxley Act also created a new watchdog agency, the **Public Company Accounting Oversight Board (PCAOB)**, to monitor the work of independent accountants who audit public companies. More recent scandals, such as the Bernie Madoff scandal in which Mr. Madoff pleaded guilty to defrauding thousands of investors by filing falsified trading reports, have further undermined the public's faith in financial reporting. This may result in more legislation that will influence future reporting.

Audit

An examination of a company's financial statements and records.

Sarbanes-Oxley Act (SOX)

Requires management to review internal control and take responsibility for the accuracy and completeness of their financial reports.

Public Company Accounting Oversight Board (PCAOB)

Monitors the work of independent accountants who audit public companies.

Try It!

Match the accounting terminology to the definitions.

- | | |
|--------------------------------|--|
| 7. Cost principle | a. oversees the creation and governance of accounting standards in the United States |
| 8. GAAP | b. requires an organization to be a separate economic unit |
| 9. Faithful representation | c. oversees U.S. financial markets |
| 10. SEC | d. states that acquired assets and services should be recorded at their actual cost |
| 11. FASB | e. creates International Financial Reporting Standards |
| 12. Monetary unit assumption | f. the main U.S. accounting rule book |
| 13. Economic entity assumption | g. assumes that an entity will remain in operation for the foreseeable future |
| 14. Going concern assumption | h. assumes that items on the financial statements are recorded in a monetary unit |
| 15. IASB | i. requires information to be complete, neutral, and free from material error |

Check your answers online in MyLab Accounting or at <https://www.pearsonglobaleditions.com/Horngren>.



WHAT IS THE ACCOUNTING EQUATION?

Learning Objective 3

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

Accounting Equation

The basic tool of accounting, measuring the resources of the business (what the business owns or has control of) and the claims to those resources (what the business owes to creditors and to the owners): $\text{Assets} = \text{Liabilities} + \text{Equity}$.

The basic tool of accounting is the **accounting equation**. It measures the resources of a business (what the business owns or has control of) and the claims to those resources (what the business owes to creditors and to the owners). The accounting equation is made up of three parts—assets, liabilities, and equity—and shows how these three parts are related. Assets appear on the left side of the equation, and the liabilities and equity appear on the right side.

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Remember, the accounting equation is an equation—so the left side of the equation always equals the right side of the equation.

Example: If a business has assets of \$230,000 and liabilities of \$120,000, its equity must be \$110,000 ($\$230,000 - \$120,000$).

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Equity} \\ \$230,000 &= \$120,000 + ? \\ \$230,000 &= \$120,000 + \$110,000 \end{aligned}$$

Assets

Assets

Economic resources that are expected to benefit the business in the future and something the business owns or has control of.

An **asset** is an economic resource that is expected to benefit the business in the future. Assets are something of value that the business owns or has control of. Cash, Merchandise Inventory, Furniture, and Land are examples of assets.

Liabilities

Liabilities

Debts that are owed to creditors.

Claims to those assets come from two sources: liabilities and equity. **Liabilities** are debts that are owed to creditors. Liabilities are something the business owes and represent the creditors' claims on the business's assets. For example, a creditor who has loaned money to a business has a claim to some of the business's assets until the business pays the debt. Many liabilities have the word *payable* in their titles. Examples include Accounts Payable, Notes Payable, and Salaries Payable.

Equity

Equity

The owners' claims to the assets of the business.

The owners of a corporation are referred to as stockholders (also called *shareholders*). The owners' claims to the assets of the business are called **equity** (also called *stockholders' equity*). Equity represents the amount of assets that are left over after the company has paid its liabilities. It is the company's net worth.

Contributed Capital

Owner contributions to a corporation.

Equity consists of two main components: contributed capital and retained earnings. Owner contributions to a corporation are referred to as **contributed capital**. A stockholder can contribute cash or other assets (such as equipment) to the business and receive capital. Contributed capital (also called *paid-in capital*) is the amount contributed to the corporation by its owners (the stockholders). The basic element of contributed capital is stock, which the corporation issues to the stockholders as evidence of their ownership. **Common stock** represents the basic ownership of every corporation.

Common Stock

Represents the basic ownership of a corporation.

Retained Earnings

Equity earned by profitable operations of a corporation that is not distributed to stockholders.

Retained earnings is the equity earned by profitable operations that is not distributed to stockholders. There are three types of events that affect retained earnings: dividends, revenues, and expenses. A profitable corporation may make distributions to stockholders



in the form of **dividends**. Dividends can be paid in the form of cash, stock, or other property. A corporation may or may not make dividend payments to the stockholders. Dividends represent decreases in retained earnings and, therefore, decrease stockholders' equity.

Revenues are earnings that result from delivering goods or services to customers. Examples of revenues are Sales Revenue, Service Revenue, and Rent Revenue. Revenues increase a corporation's retained earnings and, therefore, increase stockholders' equity.

Expenses are the costs of selling goods or services. Expenses are the opposite of revenues and, therefore, decrease retained earnings and stockholders' equity. Examples of expenses are Rent Expense, Salaries Expense, Advertising Expense, and Utilities Expense. The difference between revenue and expenses is net income or net loss. **Net income** occurs when total revenues are greater than total expenses. A net loss is the opposite. A **net loss** occurs when total expenses are greater than total revenues.

The accounting equation can now be expanded to show the components of equity.

$$\begin{array}{l} \text{ASSETS} \\ \hline \end{array} = \begin{array}{l} \text{LIABILITIES} + \\ \hline \end{array} \begin{array}{l} \text{EQUITY} \\ \hline \text{Contributed} \\ \text{Capital} + \\ \hline \text{Common} - \text{Dividends} + \text{Retained Earnings} \\ \text{Stock} \quad \quad \quad \text{Revenues} - \text{Expenses} \\ \hline \end{array}$$

A corporation can determine the change in equity from the beginning of the year to the end of the year by using the expanded components of equity. Issuances of common stock and revenues earned during the year will always increase equity, and dividends distributed and expenses incurred during the year always decrease equity. Therefore, a corporation's ending equity is calculated as follows:

$$\text{Beginning Equity} + \text{Issuance of Common Stock} - \text{Dividends Distributed} + \text{Revenues} - \text{Expenses} = \text{Ending Equity}$$

Try It!

16. Using the expanded accounting equation, solve for the missing amount.

Assets	\$ 71,288
Liabilities	2,260
Common Stock	?
Dividends	14,420
Revenues	53,085
Expenses	28,675

Check your answer online in MyLab Accounting or at <https://www.pearsonglobaleditions.com/Horngren>.

For more practice, see Short Exercises S-F:1-6 through S-F:1-8. [MyLab Accounting](#)

Dividend

A distribution of a corporation's earnings to stockholders.

Revenues

Amounts earned from delivering goods or services to customers.

Expenses

The costs of selling goods or services.

Net Income

The result of operations that occurs when total revenues are greater than total expenses.

Net Loss

The result of operations that occurs when total expenses are greater than total revenues.

HOW DO YOU ANALYZE A TRANSACTION?

Accounting is based on actual transactions. A **transaction** is any event that affects the financial position of the business *and* can be measured with faithful representation. Transactions affect what the company has (assets), owes (liabilities), and/or its net worth (equity). Many

Learning Objective 4

Use the accounting equation to analyze transactions



Transaction

An event that affects the financial position of the business and can be measured with faithful representation.

events affect a company, including economic booms and recessions. Accountants, however, do not record the effects of those events. An accountant records only those events that have dollar amounts that can be measured reliably, such as the purchase of a building, a sale of merchandise, and the payment of rent.

Transaction Analysis for Smart Touch Learning

To illustrate accounting for a business, we'll use Smart Touch Learning, the business introduced earlier. We'll account for the transactions of Smart Touch Learning during November 2024 and show how each transaction affects the accounting equation.

Transaction 1—Stockholder Contribution

Assume Sheena Bright contributes \$30,000 cash to Smart Touch Learning, a corporation, in exchange for stock. The e-learning business receives \$30,000 cash and issues common stock to Sheena Bright. The effect of this transaction on the accounting equation of the business is as follows:

ASSETS	}	=	}	LIABILITIES + EQUITY
Cash				Contributed Capital
(1) +30,000				Common Stock +30,000

Let's take a close look at the transaction above following these steps:

Step 1: Identify the accounts and the account type. Each transaction must affect at least two accounts but could affect more than two. The two accounts involved in this transaction are *Cash (Asset)* and *Common Stock (Equity)*.

Step 2: Decide if each account increases or decreases. Remember to always view this from the *business's* perspective, not from the stockholders' or customers' perspective. *Cash increases.* The business has more cash than it had before. *Common Stock increases.* The business received a \$30,000 contribution and issued stock.

Step 3: Determine if the accounting equation is in balance. For each transaction, the amount on the left side of the equation must equal the amount on the right side. $\$30,000 = \$30,000$

Transaction 2—Purchase of Land for Cash

The business purchases land for an office location, paying cash of \$20,000. This transaction affects the accounting equation of Smart Touch Learning as follows:

ASSETS	}	=	}	LIABILITIES + EQUITY
Cash + Land				Contributed Capital
Bal. \$30,000				+ Common Stock
(2) <u>-20,000</u> +20,000				<u>\$30,000</u>
Bal. \$10,000 + \$20,000				\$30,000

Let's review the transaction using the steps we learned:

Step 1: Identify the accounts and the account type. The two accounts involved are *Cash (Asset)* and *Land (Asset)*.



Step 2: Decide if each account increases or decreases. *Cash decreases.* The business paid cash and therefore has less cash. *Land increases.* The business now has land.

Step 3: Determine if the accounting equation is in balance. $\$10,000 + \$20,000 = \$30,000$

Transaction 3—Purchase of Office Supplies on Account

Smart Touch Learning buys office supplies on account (also called *buying on credit*), agreeing to pay \$500 within 30 days. This transaction increases both the assets and the liabilities of the business as follows:

ASSETS			=	LIABILITIES	+	EQUITY
Cash	+	Office Supplies		Accounts Payable	+	Contributed Capital Common Stock
Bal. \$10,000		+ \$20,000				\$30,000
(3)		+ 500		+ 500		
Bal. \$10,000	+	\$500		\$500	+	\$30,000

Step 1: Identify the accounts and the account type. The two accounts involved are *Office Supplies (Asset)* and *Accounts Payable (Liability)*. Office Supplies is an asset, not an expense, because the supplies are something of value that the company has. The office supplies aren't used up yet but will be in the future. The liability created by purchasing "on account" is an **Accounts Payable**, which is a short-term liability that will be paid in the future. A payable is always a liability.

Accounts Payable

A short-term liability that will be paid in the future.

Step 2: Decide if each account increases or decreases. *Office Supplies increases.* The business now has more office supplies than it had before. *Accounts Payable increases.* The business now owes more debt than it did before.

Step 3: Determine if the accounting equation is in balance. $\$10,000 + \$500 + \$20,000 = \$500 + \$30,000$

Notice how the steps help when analyzing transactions. It's important that, as you are learning, you use the steps to complete the transactions. Moving forward, try writing the steps out yourself before looking at the transaction analysis.

Transaction 4—Earning of Service Revenue for Cash

Smart Touch Learning earns service revenue by providing training services for clients. The business earns \$5,500 of revenue and collects this amount in cash. The effect on the accounting equation is an increase in Cash and an increase in Service Revenue as follows:

ASSETS			=	LIABILITIES	+	EQUITY	
Cash	+	Office Supplies		Accounts Payable	+	Contributed Capital Common Stock	+ Retained Earnings Service Revenue
Bal. \$10,000		+ \$20,000		\$500	+	\$30,000	
(4)		+ 5,500					+ 5,500
Bal. \$15,500	+	\$500		\$500	+	\$30,000	+ \$5,500



A revenue transaction grows the business, as shown by the increases in assets and equity.

Transaction 5—Earning of Service Revenue on Account

Smart Touch Learning performs a service for clients who do not pay immediately. The business receives the clients' promise to pay \$3,000 within one month. This promise is an asset, an **Accounts Receivable**, because the business expects to receive the cash in the future. In accounting, we say that Smart Touch Learning performed this service *on account*. It is in performing the service (doing the work), not collecting the cash, that the company *earns* the revenue. As in Transaction 4, increasing revenue increases equity. Smart Touch Learning records the earning of \$3,000 of revenue on account as follows:

Accounts Receivable
The right to receive cash in the future from customers for goods sold or for services performed.

ASSETS				=	LIABILITIES +	EQUITY	
Cash	+ Accounts Receivable	+ Office Supplies	+ Land		Accounts Payable	+ Contributed Capital	+ Retained Earnings
Bal. \$15,500		+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$5,500
(5) _____	+3,000						+3,000
Bal. \$15,500	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$8,500

The term *on account* can be used to represent either *Accounts Receivable* or *Accounts Payable*. If the business will be *receiving cash in the future*, the company will record an *Accounts Receivable*. If the business will be *paying cash in the future*, the company will record an *Accounts Payable*.

Transaction 6—Payment of Expenses with Cash

The business pays \$3,200 in cash expenses: \$2,000 for office rent and \$1,200 for employee salaries. The effects on the accounting equation are as follows:

ASSETS				=	LIABILITIES +	EQUITY			
Cash	+ Accounts Receivable	+ Office Supplies	+ Land		Accounts Payable	+ Contributed Capital	+ Service Revenue	- Rent Expense	- Salaries Expense
Bal. \$15,500	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$8,500		
(6) -3,200								-2,000	-1,200
Bal. \$12,300	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000	+ \$8,500	- \$2,000	- \$1,200

Expenses have the opposite effect of revenues. Expenses shrink the business, as shown by the decreased balances of assets and equity. Each expense is recorded separately. We record the cash payment in a single amount for the sum of the expenses: \$3,200 (\$2,000 + \$1,200). Notice that the accounting equation remains in balance (\$12,300 + \$3,000 + \$500 + \$20,000 = \$500 + \$30,000 + \$8,500 - \$2,000 - \$1,200).



Transaction 7—Payment on Account (Accounts Payable)

The business pays \$300 to the store from which it purchased office supplies in Transaction 3. In accounting, we say that the business pays \$300 *on account*. The effect on the accounting equation is a decrease in Cash and a decrease in Accounts Payable as shown here:

ASSETS					=	LIABILITIES +		EQUITY						
Cash	Accounts Receivable	Office Supplies	Land			Accounts Payable	Contributed Capital	+	Retained Earnings					
						Common Stock		Service Revenue	Rent Expense	Salaries Expense				
Bal. \$12,300	+ \$3,000	+ \$500	+ \$20,000		\$500	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200				
(7) -300					-300									
Bal. \$12,000	+ \$3,000	+ \$500	+ \$20,000		\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200				

The payment of cash on account has no effect on the amount of Office Supplies (Asset). Smart Touch Learning has not increased the amount of its office supplies; instead, it is paying off a liability (Accounts Payable decreased \$300) with cash (Cash decreased \$300). **To record an increase to Office Supplies, in this transaction, would be accounting for the purchase of office supplies twice.** We have already recorded the purchase of office supplies in Transaction 3; in this transaction, we are now ready to record only the payment on account.

Transaction 8—Collection on Account (Accounts Receivable)

In Transaction 5, the business performed services for clients on account. Smart Touch Learning now collects \$2,000 from a client. We say that Smart Touch Learning collects the cash *on account*. The business will record an increase in the asset Cash. Should it also record an increase in Service Revenue? No, because the business already recorded the revenue when it earned the revenue in Transaction 5. The phrase “collect cash on account” means to record an increase in Cash and a decrease in Accounts Receivable. Accounts Receivable is decreased because the \$2,000 that the business was to collect at some point in the future is being collected today. The effect on the accounting equation is as follows:

ASSETS					=	LIABILITIES +		EQUITY						
Cash	Accounts Receivable	Office Supplies	Land			Accounts Payable	Contributed Capital	+	Retained Earnings					
						Common Stock		Service Revenue	Rent Expense	Salaries Expense				
Bal. \$12,000	+ \$3,000	+ \$500	+ \$20,000		\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200				
(8) +2,000	-2,000													
Bal. \$14,000	+ \$1,000	+ \$500	+ \$20,000		\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200				

This transaction is recorded as an increase in one asset (Cash) and a decrease in another asset (Accounts Receivable). Is the accounting equation still in balance? Yes. **As long as you record an increase and decrease of the same amount on one side of the accounting equation, the accounting equation remains in balance.** In other words, total Assets, Liabilities, and Equity are all unchanged from the preceding total. Why? Because Smart Touch Learning exchanged one asset (Cash) for another (Accounts Receivable), causing a zero effect on the total amount of assets in the accounting equation (+\$2,000 - \$2,000 = \$0).

Why didn't we record an increase to Office Supplies? We are making a payment for the supplies; wouldn't we increase Office Supplies and decrease Cash?



Don't I have to put an amount on the left side of the accounting equation and an amount on the right side of the accounting equation for the equation to balance?





Transaction 9—Payment of Cash Dividend

Smart Touch Learning distributes a \$5,000 cash dividend to the stockholder, Sheena Bright. The effect on the accounting equation is as follows:

ASSETS				}	=	}	LIABILITIES +	EQUITY				
Cash	+ Accounts Receivable	+ Office Supplies	+ Land				Accounts Payable	+ Contributed Capital	+ Retained Earnings			
								+ Common Stock	- Dividends	+ Service Revenue	- Rent Expense	- Salaries Expense
Bal. \$14,000	+ \$1,000	+ \$500	+ \$20,000				\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(9) -5,000									-5,000			
Bal. \$ 9,000	+ \$1,000	+ \$500	+ \$20,000				\$200	+ \$30,000	- \$5,000	+ \$8,500	- \$2,000	- \$1,200

The dividend decreases the business's cash and equity. *Dividends do not represent an expense because they are not related to the earning of revenue. Therefore, dividends do not affect the business's net income or net loss.*

A summary of all nine transactions for Smart Touch Learning is presented in Exhibit F:1-6.

Exhibit F:1-6 Analysis of Transactions, Smart Touch Learning

1. Received \$30,000 cash and issued common stock to Sheena Bright, stockholder
2. Paid \$20,000 cash for land
3. Bought \$500 of office supplies on account
4. Received \$5,500 cash from clients for service revenue earned
5. Performed services for clients on account, \$3,000
6. Paid cash expenses: office rent, \$2,000; employee salaries, \$1,200
7. Paid \$300 on the accounts payable created in Transaction 3
8. Collected \$2,000 on the accounts receivable created in Transaction 5
9. Paid cash dividends of \$5,000 to stockholder, Sheena Bright

ASSETS				}	=	}	LIABILITIES +	EQUITY				
Cash	+ Accounts Receivable	+ Office Supplies	+ Land				Accounts Payable	+ Contributed Capital	+ Retained Earnings			
								+ Common Stock	- Dividends	+ Service Revenue	- Rent Expense	- Salaries Expense
(1) +30,000								+30,000				
(2) -20,000			+20,000									
Bal. \$10,000			+ \$20,000					\$30,000				
(3)		+500					+500					
Bal. \$10,000		+ \$500	+ \$20,000				\$500	+ \$30,000				
(4) +5,500										+5,500		
Bal. \$15,500		+ \$500	+ \$20,000				\$500	+ \$30,000		+ \$5,500		
(5)	+3,000									+3,000		
Bal. \$15,500	+ \$3,000	+ \$500	+ \$20,000				\$500	+ \$30,000		+ \$8,500		
(6) -3,200											-2,000	-1,200
Bal. \$12,300	+ \$3,000	+ \$500	+ \$20,000				\$500	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(7) -300							-300					
Bal. \$12,000	+ \$3,000	+ \$500	+ \$20,000				\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(8) +2,000	-2,000											
Bal. \$14,000	+ \$1,000	+ \$500	+ \$20,000				\$200	+ \$30,000		+ \$8,500	- \$2,000	- \$1,200
(9) -5,000									-5,000			
Bal. \$ 9,000	+ \$1,000	+ \$500	+ \$20,000				\$200	+ \$30,000	- \$5,000	+ \$8,500	- \$2,000	- \$1,200
\$30,500							\$30,500					



Try It!

17. Using the information provided, analyze the effects of Lawlor Lawn Service's transactions on the accounting equation.

May 1	Received \$1,700 and issued common stock.
May 3	Purchased a mower on account, \$1,440.
May 5	Performed lawn services for client on account, \$200.
May 17	Paid \$60 cash for gas used in mower.
May 28	Paid cash dividends of \$300.

Check your answers online in MyLab Accounting or at <https://www.pearsonglobal editions.com/Horngren>.

For more practice, see Short Exercises S-F:1-9 and S-F:1-10. [MyLab Accounting](#)

HOW DO YOU PREPARE FINANCIAL STATEMENTS?

We have now recorded Smart Touch Learning's transactions, and they are summarized in Exhibit F:1-6. Notice how total assets equal total liabilities plus equity ($\$30,500 = \$30,500$).

But a basic question remains: How will people actually use this information? The information in Exhibit F:1-6 does not tell a lender whether Smart Touch Learning can pay off a loan. The exhibit does not tell whether the business is profitable.

To address these important questions, we need financial statements. **Financial statements** are business documents that are used to communicate information needed to make business decisions. Four financial statements are prepared. These statements are prepared in the order listed in Exhibit F:1-7.

Because financial statements are used to communicate information, they always include a heading with important details about the reports. The standard three-line heading tells the reader of the statement who, what, and when—the name of the business, the title of the report, and the specific date or time period of the report.

Learning Objective 5

Prepare financial statements

Financial Statements

Business documents that are used to communicate information needed to make business decisions.

Exhibit F:1-7 | Financial Statements

Financial Statement	Information Provided and Purpose	How Is It Prepared?
Income statement	Provides information about profitability for a particular period for the company	Revenues – Expenses = Net Income or Net Loss
Statement of retained earnings	Informs users about how much of the earnings were kept and reinvested in the company	Retained Earnings, Beginning + Net Income or – Net Loss for the period – Dividends for the period = Retained Earnings, Ending
Balance sheet	Provides valuable information to financial statement users about economic resources the company has (assets) as well as debts the company owes (liabilities), and allows decision makers to determine their opinion about the financial position of the company	Assets = Liabilities + Stockholders' Equity
Statement of cash flows	Reports on a business's cash receipts and cash payments for a period of time	Cash flows from operating activities Cash flows from investing activities Cash flows from financing activities



Income Statement

Income Statement

Reports the *net income* or *net loss* of the business for a specific period.

Let's start by reviewing the **income statement**. The income statement (also called the *statement of earnings*) presents a summary of a business entity's revenues and expenses for a period of time, such as a month, quarter, or year. The income statement tells us whether the business enjoyed net income or suffered a net loss. Remember:

- Net income means total revenues are greater than total expenses.
- Net loss means total expenses are greater than total revenues.

It's important to remember that the only two types of accounts that are reported on the income statement are revenues and expenses. Exhibit F:1-8 shows the income statement for Smart Touch Learning. Every income statement contains similar information.

Exhibit F:1-8 | Income Statement

SMART TOUCH LEARNING Income Statement Month Ended November 30, 2024	
Revenues:	
Service Revenue	\$ 8,500
Expenses:	
Rent Expense	\$ 2,000
Salaries Expense	1,200
Total Expenses	3,200
Net Income	<u>\$ 5,300</u>

The heading includes the name of the business, the title of the statement, and the time period. An income statement always represents a period of time, for example, a month or year.

The revenue accounts are always listed first and then subtotaled if necessary.

Each expense account is listed separately from largest to smallest and then subtotaled if necessary.

Net income is calculated as total revenues minus total expenses.

Statement of Retained Earnings

Statement of Retained Earnings

Reports how the company's retained earnings balance changed from the beginning to the end of the period.

The next statement prepared is the **statement of retained earnings**. The statement of retained earnings shows the changes in retained earnings for a business entity during a time period, such as a month, quarter, or year.

Review the statement of retained earnings for Smart Touch Learning in Exhibit F:1-9. Notice that the net income for the month is the net income that was calculated on the income statement. This is the main reason why the income statement is prepared before the statement of retained earnings. The net income (or net loss) must first be calculated on the income statement and then carried to the statement of retained earnings.


Exhibit F:1-9 | Statement of Retained Earnings

SMART TOUCH LEARNING Statement of Retained Earnings Month Ended November 30, 2024	
Retained Earnings, November 1, 2024	\$ 0
Net income for the month	5,300
	<u>5,300</u>
Dividends	(5,000)
Retained Earnings, November 30, 2024	<u>\$ 300</u>

The heading includes the name of the business, the title of the statement, and the time period. A statement of retained earnings always represents a period of time.

The beginning retained earnings is \$0 because Smart Touch Learning began this month; therefore, it had no beginning retained earnings. The beginning retained earnings will always be the ending retained earnings from the previous time period.

Net income is transferred from the income statement.

The dividends are subtracted from retained earnings. If there had been a net loss rather than a net income, this would also be subtracted.

Balance Sheet

Reports on the assets, liabilities, and stockholders' equity of the business as of a specific date.

Balance Sheet

The **balance sheet** (also called the *statement of financial position*) lists a business entity's assets, liabilities, and stockholders' equity as of a specific date, usually the end of a month, quarter, or year. **The balance sheet is a snapshot of the entity. An investor or creditor can quickly assess the overall health of a business by viewing the balance sheet.**

Review the balance sheet for Smart Touch Learning in Exhibit F:1-10. Every balance sheet is prepared in a similar manner.

What does the balance sheet tell an investor or creditor?


Exhibit F:1-10 | Balance Sheet

SMART TOUCH LEARNING Balance Sheet November 30, 2024			
Assets		Liabilities	
Cash	\$ 9,000	Accounts Payable	\$ 200
Accounts Receivable	1,000		
Office Supplies	500	Stockholders' Equity	
Land	20,000	Common Stock	30,000
		Retained Earnings	300
		Total Stockholders' Equity	<u>30,300</u>
Total Assets	<u>\$ 30,500</u>	Total Liabilities and Stockholders' Equity	<u>\$ 30,500</u>

Each asset account is listed separately and then totaled. Cash is always listed first.

The heading again shows the name of the business and the title of the financial statement. Notice that the date is different. The balance sheet shows the date as a specific date, not a period of time.

Liabilities are listed separately and then totaled. Liabilities that are to be paid first are listed first.

Retained Earnings is taken directly from the statement of retained earnings.

The balance sheet must always balance.
Assets = Liabilities + Stockholders' Equity