### Chapter 1

### An Introduction to Accounting

### General Comments for Chapter 1

Most students come to class the first day without a textbook. Even after students have the textbook, many of them do not read assigned chapters prior to attending class. Many students do not have the skill necessary to read technical material without some initial oral explanation. They need help getting started. Consider allowing students to read the chapter after you introduce the concepts in class. We would certainly prefer that our students read the text prior to class. Most are incapable of doing so. Therefore, we assume that initial exposure to new concepts occurs in class. Under this assumption, there is no difference between the first day of class and any other day.

The primary objective of the text is to teach students to understand how business events affect financial statements. The first step is for students to learn the elements of financial statements. This chapter introduces the following elements: assets, liabilities, equity, common stock, retained earnings, revenue, expenses, and distributions. Next, students must learn how the elements are interrelated, and finally, how those interrelationships are expressed in financial statements.

This first chapter introduces several terms and concepts that may be new to many, if not all, students. This chapter also lays an important foundation for the rest of the course. Since students are settling in to the new semester or quarter, and since there are often changes in class composition due to add/drop activity during the first week of class, we suggest more time be allocated to cover material in this chapter.

There are two distinct ways to introduce financial accounting using this text. One alternative is to first introduce financial statements and then show students how to record events in the horizontal financial statements model. The second alternative is to show students how to record transaction data using the accounting equation and then to develop financial statements from the data organized in equation form. The text supports either approach. In the following section, we provide detailed lesson plans for both approaches.

### Detailed Outline of a Lesson Plan for Chapter 1

**(Horizontal Financial Statements Model Approach)**

 **I. Use the problem-based learning case, “Ask Me Anything,” to introduce financial statements to students.**

(We describe problem-based learning in the introduction to this manual.)

Instructions: The case appears on the following page in a format you can copy or display. Distribute copies of the case to the class before providing any explanation of accounting. Ask students to read the case and individually develop answers.

Chapter 1 Problem-Based Learning Case: Accounting Questions

**Ask Me Anything**



***Assume that you are considering going into business with Linda Wilson. Assume that I am Linda’s accountant and that you can ask me three questions. Write down the three questions that you would ask.***

 **II. Create a collaborative experience where students share their questions.** After allowing students time to develop their individual responses, put them into groups to compare their questions. For example, have students pair off with one another, share their questions, and reach consensus on three questions that represent the combined interest of the two people in the pair.Then combine those pairs of students into groups of four, and have each group select three of their original sixquestions that they would ask the accountant. Allow groups time to develop answers. Also have each group select a spokesperson.

 **III. Briefly introduce the basic financial statements.** Explain that accountants communicate financial information to the public through a set of reports called financial statements. At this point introduce three of these statements: 1) the balance sheet, 2) the income statement, and 3) the statement of cash flows. Use a business cycle approach to introduce the statement of cash flows. Specifically, starting a business requires some cash (financing activities); the cash is used to buy operating assets (investing activities); and finally, the business runs on a day-to-day basis (operating activities).

 **IV. Use student input to demonstrate the usefulness of financial statement information.** Ask the group spokespersons to share the questions their group would like to have the accountant answer. Identify information that would appear in financial statements. For example, “How much money does Linda make?” would appear as revenue on the income statement. Draw a skeleton of an income statement on the board and show the students where revenue appears on that statement. You could use this question to expand the discussion into other areas. Ask, for example, “Is the amount of Linda’s salary equal to the amount of her take-home pay?” This question creates an opportunity to demonstrate the difference between the income statement and the statement of cash flows. A question like “Does she pay her bills on time?” affords the opportunity to explain that some information is not provided directly in the statements but is available through financial statement analysis. Some questions provide the opportunity to demonstrate the limitations of financial statement data. For example, answers to questions like “Is Linda an honest person?” cannot be found in the financial statements. However, this question invites you to point out the importance of ethical conduct by accountants.

 We hope these examples demonstrate the need for the instructor to be flexible and creative in handling the student input. Expect a variety of questions. Also, be prepared to raise questions if the students do not ask about some of the things you want to discuss. Problem-based learning is designed to provide an opportunity for student discovery, not discovery on the part of the professor. The instructor should be prepared to address predetermined learning objectives. In this case, one objective is to introduce financial statements in a way that engages students. The exercise is designed to stimulate student interest and critical thinking. The primary learning objective, however, is for students to leave class able to name three financial statements and to describe the specific elements that appear in each statement. The instructor should guide the discussion toward the accomplishment of these objectives.

 **V. Distribute copies of the Self Study Review Problem**. The self-study review problem immediately follows the text at the end of each chapter, just before the listing of key terms. After establishing an understanding of financial statements, you can use this problem to show students how to record business events directly into a set of financial statements. The solutions are included in the text so that students can refer back as they review the material covered during class. You can mention this to the students before you begin working on the problem. This way, the students can focus their attention on the class discussion rather than focusing their attention on taking notes and recording your comments. The material is also supplemented with narrated slides to help students if they cannot recall details of the discussion in class.

**VI. Create a horizontal financial statements model for the Self-Study Review Problem**. Either draw on the board or use an e-transparency to display a horizontal financial statements model for the students. Explain that the statements model is a learning tool that doesn’t include many details (titles, dates, headings, etc.) that normally appear in formal financial statements. In lecture mode, analyze and record the transactions. Each transaction introduces a new financial statement element. Provide a clear explanation of each element including the interrelationships between elements and their statements effects. For example, describe revenue as an economic benefit a company obtains by providing customers with goods and services. Revenue causes an increase in equity and a corresponding increase in assets. At this early point, you can limit the explanation of revenue to an increase in equity with a corresponding increase in assets. How does revenue differ from issuing stock which also results in an increase in assets? Revenue results from work performed by the company, while a successful stock issue results from convincing stockholders that the company can produce revenue. Point out that revenue is reported on the income statement but a stock issue is not. Similarly, describe each element and show the students how the business events affect the financial statements.

1. **Actively involve the students in learning**. After explaining the accounting transactions in the self-study review problem, show how last year’s ending balances became this year’s beginning balances. Record the ending balances in a statements model. Observe that the balance sheet accounts carry forward from year to year while the income statement accounts are closed, resulting in zero beginning balances for all revenue and expense accounts. This is an excellent time to mention the closing process without getting into procedural detail. Sometimes it helps students understand that the way we record revenue and expense transactions in the horizontal financial statements model actually combines 2 entries into 1 – the entry to record the transaction and the entry to close the revenues and expenses to equity. After explaining the self-study review problem, ask the students to complete Exercise 1-11B or the Demonstration problem (at the end of this section of the Instructor’s Manual) on their own. You will probably need to make copies of whichever item you ask them to complete, since not all students will bring their text to class every day. The value of the Demonstration problem is that it allows the students to see how to move from one fiscal period to the next. Walk around the room and provide assistance as needed. If you notice that a particular transaction is confusing a lot of students, stop the class and provide a brief explanation to the class as a whole.

### Detailed Outline of an Alternative Lesson Plan for Chapter 1

**(Equation Approach)**

 **I. Distribute copies of the Self-Study Review Problem**. As indicated earlier, the self study problem and solution is located immediately after the text at the end of each chapter.

 **II.** **Define assets**. Use the simplest definition possible. It is extremely important to use words that students can understand. They will read the technical terminology in the text. For example:

Assets are things of value to a business. The value is the capacity of the asset to be used in the production of greater quantities of other assets.

 Use the classroom to provide specific examples. For example, the chairs, desks, and building the students are using are assets of the university because they are used to produce tuition dollars (other assets). Emphasize the point further by distinguishing between personal assets and business assets. Tom uses an old key chain his brother gave him over twenty years ago. While it has great value to Tom, it would have little value to a business because it could not be sold or otherwise used to produce other assets. If you saw this key chain you would truly understand its limitations as a business asset. You may not have an old key chain, but we’re sure you can think of something meaningful to you that has little usefulness as a business asset. Nancy uses framed photographs of her beautiful daughters. It is important that you personalize your comments. We highly encourage you to adapt our examples to reflect your personality. Students respond favorably to personalized examples. Often students have often heard the statement that ‘people are our most valuable assets’. This is a great time to distinguish between the accounting concept of an asset and the intangible value of key employees.

**III.** **Introduce the accounting equation.** You can make a smooth transition from defining assets to introducing the accounting equation by noting that ***assets*** belong to some person or organization. The individual or institutional interests in the assets are called ***claims***. The ***accounting equation*** expresses the relationship between assets and claims as follows:

|  |  |  |
| --- | --- | --- |
| Assets | = | Claims |

**IV. Use the Self Study Problem that follows the text in Chapter 1 as an explanatory platform.** Using the Self Study Problems in the text to explain concepts allows the students to focus their attention entirely on your explanation rather than trying to take notes and capture all your comments for future reference and study support. Since the text also illustrates the solution to this self study problem, the students can use the text to refresh their memories when completing assigned homework or studying for tests. The narrated slides can also serve to remind students of the classroom discussion.

 Explain that individuals or institutions acquire claims by providing assets to a business. ***There are three primary sources of assets***. The first two events of the self-study problem illustrate the two of the three sources. Discuss each event separately. Define the appropriate terms, and explain how the event affects the accounting equation.

**A. Event No. 1:** Use Event No. 1 to introduce and define ***common stock***. Explain that when a business acquires assets from owners, the assets of the business increase and the business establishes a corresponding ***claims account*** called ***common stock***. Introduce the accounting equation and the term ***equity***. Show students how to record the event under the accounting equation. Record common stock under the term equity. Leave room for retained earnings which will be illustrated in Event No. 2. Note that equity represents ownership interest in the business.

**B. Event No. 2:** This event introduces the concept of ***revenue***. Define revenue as an ***increase in assets*** resulting from the operating activities of providing services or goods to customers.[[1]](#footnote-1) This definition defines revenue in terms of its relationship with assets. It is essential that students understand how the elements of financial statements articulate. You can achieve this goal by defining various elements in terms of their relationship to other elements. Expand the accounting equation to include retained earnings and record Event No. 3 under the equation.

**C. I**ntroduce ***liabilities*** and tell the students that creditors also have an interest in the assets of a business. Define liabilities as ***obligations of a business***.

Identify Events 1 and 2, along with liabilities, as ***asset source transactions***. Emphasize that thousands of different events can be classified into one of these three types of transactions. For example, businesses may increase their assets by providing consulting services, cleaning services, music lessons, investment advice, legal services, medical assistance, mechanical work, painting, and so on. Although these services represent distinctly different events, they can all be classified as asset source transactions. Emphasize that *it is* *easier to understand the three types of transactions* than *to memorize* the infinite number of specific transactions in which businesses engage. The next two events represent ***asset use transactions***.

**D. Event No. 3:** This event introduces the concept of ***asset use*** (cash) to pay ***expenses***. Define expenses as ***decreases in assets*** that occur in the process of attempting to earn revenue. Explain that assets are used to settle or pay for the expenses incurred in the earnings process.

**E. Event No. 4:** This event introduces ***dividends***. Clearly distinguish dividends from expenses. Although both are ***asset use*** transactions, dividends represent ***a transfer of wealth*** rather than a sacrifice made to obtain revenue.

**F. Event No. 5**: This event introduces the concept of ***asset exchange***. Explain how assets (generally cash) can be exchanged for other assets (like land, in this example) and how the total asset balance doesn’t change when an asset exchange occurs.

**G**. **Event No. 6:** This event reinforces the concept of ***asset use***.

**V. Introduce the horizontal financial statements model** to show your students how to record the effects (increase, decrease, no effect) of transactions on the statements, using the transactions from the Self-Study Review problem. Link the horizontal financial statements model to the accounting equation and show how every transaction leaves the accounting equation in balance.

**VI. Actively involve the students in learning**. After explaining the accounting transactions in the Self-Study Review problem, show how last year’s ending balances became this year’s beginning balances. Record the ending balances in a statements model. Observe that the balance sheet accounts carry forward from year to year while the income statement accounts are closed, resulting in zero beginning balances for all revenue and expense accounts. This is an excellent time to mention the closing process without getting into procedural detail. It sometimes helps students understand that revenue, expense, and dividend transactions recorded in the financial statement model actually combine 2 transactions into 1 – the recording of the event itself plus the recording of the closing transaction.

After explaining the Self-Study Review problem, ask the students to complete Exercise 1-11B or the Demonstration problem (at the end of this section of the Instructor’s Manual) on their own. You will probably need to make copies of whichever item you ask them to complete, since not all students will bring their text to class every day. The value of the Demonstration problem is that is allows the students to see how to move from one fiscal period to the next. Walk around the room and provide assistance as needed. If you notice that a particular transaction is confusing a lot of students, stop the class and provide a brief explanation to the class as a whole.

**VII. Introduce financial statements.** Return to the Self-Study Review problem and show students how the information recorded in the accounting equation and horizontal financial statements model is summarized in financial statements. Emphasize that financial statements are designed to provide information useful in decision-making. This is a good time to say a few words about the different types of accounting information. Explain how outsiders (e.g., investors and creditors) need different kinds of information than insiders (e.g., managers). For example, a person deciding whether to invest in Kmart versus Wal-Mart is interested in knowing which company generated more earnings. In contrast, a Wal-Mart vice-president needs information about specific stores and specific items in each store. Different branches of accounting have been established to satisfy the information needs of different users. Emphasize that financial accounting focuses on the information needs of investors and creditors. Make the discussion light and breezy. Students quickly get bored with this kind of general discussion.

 Present the statements in this order: (1) income statement, (2) statement of changes in stockholders’ equity, (3) balance sheet, and (4) statement of cash flows. As you explain, point out the importance of this sequence. You need the amount of net income to prepare the statement of changes in stockholders’ equity. You need the amount of stockholders’ equity to prepare the balance sheet. Comments relevant to each statement follow:

**A. Income statement.**  Emphasize how the elements of the income statement are related to the elements of the balance sheet. Reiterate that revenue increases assets from providing services and expenses decrease assets in efforts to earn revenue. Teach students more than the formula for computing net income (Revenue – Expenses = Net Income). Help them understand that net income represents the change in wealth (net assets) resulting from business operations during the accounting period. If you want your students to understand interrelationships, you must emphasize those relationships in your classroom discussions and your examinations.

**B. Statement of changes in stockholders’ equity.** This statement provides the opportunity to reemphasize the difference between expenses and dividends. Expenses affect the measurement of net income, after which a decision is made regarding how much of the income to distribute versus how much to retain in the business. Emphasize that net income is a periodic measurement, while retained earnings is a cumulative amount.

**C. Balance sheet.** Explain that the balance sheet is little more than a summary of the accounting equation. The statement lists assets and the corresponding claims on those assets. In this chapter, too few assets are illustrated to introduce the idea of presenting assets in accordance with liquidity. This subject is introduced later in the text. Explain that the statement represents a company’s financial condition at a specific point in time.

**D. Statement of cash flows.** Introduce the categories of the statement of cash flows in a sequence consistent with forming a business. First, a business must obtain ***financing***. Once a business has cash, it ***invests*** the cash. Finally, the business uses and generates cash through its ***operating activities***. Use the direct method. Prepare the statement by analyzing the cash account. Students must merely learn to identify cash transactions as operating, investing, or financing. Many students find this task to be a real challenge. Do not be discouraged if your students have difficulty at first. While mastery requires a significant level of reinforcement, be assured that your students will grasp this critically important topic after working through several of the multicycle problems. Since the first chapter covers only cash transactions, the amount of cash flow from operating activities will equal the amount of net income. Therefore, we do not contrast these two amounts until Chapter 2. Instead, we emphasize that the statement of cash flows is more inclusive than the income statement. We point out that it reports investing and financing activities as well as operating activities.

 **VIII. Fill in the gaps.**  You will find additional terms and concepts covered in the text but not in the teaching notes. Although we do not expect our students to read the text prior to coming to class, we do expect them to read it after we have introduced the material. In other words, we expect our students to read behind us. They are responsible for filling in the gaps. There is not enough time to cover every single point in class. Class is a place to get started. Try to cover the more important and conceptually complex points there. Hold your students responsible for a reasonable level of homework. Remind them accounting is a “learn by doing” subject. Regardless of how skillfully you explain the concepts, students cannot learn to work accounting problems without actually working accounting problems.

**IX. Enrichment.** Appendix B contains excerpts from the Target 10-K report. It helps students to see a ‘real world’ example of what is being covered in class. While they are not yet ready to fully analyze financial statements as complex as those presented in this Appendix, you can point out the fact that the 4 financial statements are included here and discuss how they tie to the example that has been covered in class.

### Demonstration Problem 1-1 - The Accounting Cycle

The events below apply to Computer Services Company (CSC). Assume that all transactions involve receiving or paying cash.

Transactions for the year 2015:

1. CSC was started when it acquired $9,000 cash by issuing common stock.

2. The company borrowed $5,000 from a bank.

3. The company provided services to customers and received $4,000.

4. The company paid operating expenses of $2,900.

5. The company paid $500 in dividends to its stockholders.

Transactions for the year 2016:

1. The company issued additional common stock for $4,500.

2. The company paid $2,000 to reduce its liabilities.

3. The company provided services to customers and received $6,700.

4. The company paid operating expenses of $4,300.

5. The company paid $700 in dividends to its stockholders.

Transactions for the year 2017:

1. The company issued additional common stock for $2,500.

2. The company borrowed an additional $1,000 from creditors.

3. The company provided services to customers and received $7,400.

4. The company paid operating expenses of $7,900.

5. The company paid $300 in dividends to its stockholders.

6. The company paid $9,000 to purchase land.

**Required**

a. Record the events using the horizontal financial statements model.

b. Prepare an income statement, statement of changes in stockholders’ equity, balance sheet and statement of cash flows for each year.

**Demonstration Problem 1-1 Solution, part a.**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **2015** |  |  **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| ***No.*** |  | ***Cash*** | ***+*** | ***Land*** | ***=*** | ***Liab.*** | ***+*** | ***C. Stk.*** | **+** | ***Ret. Earn.*** |  |  |  |  |  |  |  |  |  |
| **Beg. bal.** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **1** |  | **9,000** | **+** |  | **=** |  | **+** | **9,000** | **+** |  |  |  | **–** |  | **=** |  |  |  **9,000 FA** |  |
| **2** |  | **5,000** | **+** |  | **=** |  **5,000** | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  **5,000 FA** |  |
| **3** |  | **4,000** | **+** |  | **=** |  | **+** |  | **+** | **4,000** |  | **4,000** | **–** |  | **=** | **4,000** |  |  **4,000 OA** |  |
| **4** |  | **(2,900)** | **+** |  | **=** |  | **+** |  | **+** | **(2,900)** |  |  | **–** | **2,900** | **=** | **(2,900)** |  |  **(2,900) OA** |  |
| **5** |  | **(500)** | **+** |  | **=** |  | **+** |  | **+** | **(500)** |  |  | **–** |  | **=** |  |  |  **(500) FA** |  |
| **Totals** |  | **14,600** | **+** |  | **=** |  **5,000** | **+** | **9,000** | **+** | **600** |  | **4,000** | **–** | **2,900** | **=** | **1,100** |  |  **14,600 NC** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **2016** |  | **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| ***No.*** |  | ***Cash*** | ***+*** | ***Land*** | ***=*** | ***Liab.*** | ***+*** | ***C. Stk.*** | **+** | ***Ret. Ear.*** |  |  |  |  |  |  |  |  |  |
| **Beg. bal.** |  | **14,600** | **+** |  | **=** | **5,000** | **+** | **9,000** | **+** | **600** |  |  | **–** |  | **=** |  |  |  |  |
| **1** |  | **4,500** | **+** |  | **=** |  | **+** | **4,500** | **+** |  |  |  | **–** |  | **=** |  |  |  **4,500 FA** |  |
| **2** |  | **(2,000)** | **+** |  | **=** | **(2,000)** | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  **(2,000) FA** |  |
| **3** |  | **6,700** | **+** |  | **=** |  | **+** |  | **+** | **6,700** |  | **6,700** | **–** |  | **=** | **6,700** |  |  **6,700 OA** |  |
| **4** |  | **(4,300)** | **+** |  | **=** |  | **+** |  | **+** | **(4,300)** |  |  | **–** | **4,300** | **=** | **(4,300)** |  | **(4,300) OA** |  |
| **5** |  | **(700)** | **+** |  | **=** |  | **+** |  | **+** | **(700)** |  |  | **–** |  | **=** |  |  |  **(700) FA** |  |
| **Totals** |  | **18,800** | **+** |  | **=** |  **3,000** | **+** | **13,500** | **+** | **2,300** |  | **6,700** | **–** | **4,300** | **=** | **2,400** |  |  **4,200 NC** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **2017** |  | **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| ***No.*** |  | ***Cash*** | ***+*** | ***Land*** | ***=*** | ***Liab.*** | ***+*** | ***C. Stk.*** | **+** | ***Ret. Ear.*** |  |  |  |  |  |  |  |  |  |
| **Beg. bal.** |  | **18,800** | **+** |  | **=** |  **3,000** | **+** | **13,500** | **+** | **2,300** |  |  | **–** |  | **=** |  |  |  |  |
| **1** |  | **2,500** | **+** |  | **=** |  | **+** | **2,500** | **+** |  |  |  | **–** |  | **=** |  |  |  **2,500 FA** |  |
| **2** |  | **1,000** | **+** |  | **=** |  **1,000** | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  **1,000 FA** |  |
| **3** |  | **7,400** | **+** |  | **+** |  | **+** |  | **+** | **7,400** |  | **7,400** | **–** |  | **=** | **7,400** |  |  **7,400 OA** |  |
| **4** |  | **(7,900)** | **+** |  | **+** |  | **+** |  | **+** | **(7,900)** |  |  | **–** | **7,900** | **=** | **(7,900)** |  |  **(7,900) OA** |  |
| **5** |  | **(300)** | **+** |  | **+** |  | **+** |  | **+** | **(300)** |  |  | **–** |  | **=** |  |  |  **(300) FA** |  |
| **6** |  | **(9,000)** | **+** | **9,000** | **+** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  **(9,000) IA** |  |
| **Totals** |  | **12,500** | **+** | **9,000** | **+** |  **4,000** | **+** | **16,000** | **+** | **1,500** |  | **7,400** | **–** | **7,900** | **=** | **(500)** |  |  **(6,300) NC** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

 **Demonstration Problem 1-1 Solution, part b. Financial Statements**

|  |
| --- |
| **Computer Services Company** |
| **Income Statements** |
| **For the Years Ended December 31,** |  | **2015** |  | **2016** |  | **2017** |  |
| **Services revenue** |  | **$4,000** |  | **$6,700** |  | **$7,400** |  |
| **Operating expenses** |  | **(2,900)** |  | **(4,300)** |  | **(7,900)** |  |
| **Net income (loss)** |  | **$1,100** |  | **$2,400** |  | **$( 500)** |  |
|  |  |  |  |  |  |  |  |
| **Statements of Changes in Stockholders’ Equity** |
| **Beginning common stock** |  | **$ 0** |  | **$ 9,000** |  | **$13,500** |  |
| **Plus: Common stock issued** |  | **9,000** |  | **4,500** |  | **2,500** |  |
| **Ending common stock** |  | **9,000** |  | **13,500** |  | **16,000** |  |
| **Beginning retained earnings** |  |  **0** |  |  **600** |  |  **2,300** |  |
| **Plus: Net income (loss)** |  | **1,100** |  | **2,400** |  | **(500)** |  |
| **Less: Dividends** |  | **(500)** |  | **(700)** |  | **(300)** |  |
| **Ending retained earnings** |  |  **600** |  |  **2,300** |  |  **1,500** |  |
| **Total stockholders’ equity** |  | **$9,600** |  | **$15,800** |  | **$17,500** |  |
|  |  |  |  |  |  |  |  |
| **Balance Sheets at December 31** |
| **Assets** |  |  |  |  |  |  |  |
|  **Cash** |  | **$14,600** |  | **$18,800** |  | **$12,500** |  |
|  **Land** |  |  **0** |  |  **0** |  | **9,000** |  |
| **Total assets** |  | **$14,600** |  | **$18,800** |  | **$21,500** |  |
|  |  |  |  |  |  |  |  |
| **Liabilities** |  | **$ 5,000** |  | **$ 3,000** |  | **$ 4,000** |  |
|  |  |  |  |  |  |  |  |
| **Stockholders’ equity** |  |  |  |  |  |  |  |
|  **Common stock** |  |  **9,000** |  | **13,500** |  | **16,000** |  |
|  **Retained earnings** |  | **600** |  | **2,300** |  | **1,500** |  |
| **Total stockholders’ equity** |  |  **9,600** |  | **15,800** |  | **17,500** |  |
| **Total liabilities and stockholders’ equity** |  | **$14,600** |  | **$18,800** |  | **$21,500** |  |
|  |  |  |  |  |  |  |  |
| **Statements of Cash Flows** |
| **Cash flows from operating activities** |  |  |  |  |  |  |  |
|  **Cash inflows from revenue** |  | **$ 4,000** |  | **$ 6,700** |  | **$ 7,400** |  |
|  **Cash outflows for operating expenses** |  | **(2,900)** |  | **(4,300)** |  | **(7,900)** |  |
| **Net cash flow from operating activities** |  |  **1,100** |  |  **2,400** |  |  **(500)** |  |
|  |  |  |  |  |  |  |  |
| **Cash flow from investing activities** |  |  |  |  |  |  |  |
|  **Cash outflow for land** |  |  |  |  |  |  **(9,000)** |  |
|  |  |  |  |  |  |  |  |
| **Cash flows from financing activities** |  |  |  |  |  |  |  |
|  **Cash inflows from borrowing** |  |  **5,000** |  |  |  |  **1,000** |  |
|  **Cash outflows to reduce debt** |  |  |  | **(2,000)** |  |  |  |
|  **Cash inflows from stock issues** |  | **9,000** |  | **4,500** |  | **2,500** |  |
|  **Cash outflows for dividends** |  | **(500)** |  | **(700)** |  | **(300)** |  |
| **Net cash flows from financing activities** |  | **13,500** |  |  **1,800** |  |  **3,200** |  |
|  |  |  |  |  |  |  |  |
| **Net change in cash** |  | **14,600** |  |  **4,200** |  |  **(6,300)** |  |
| **Beginning cash balance** |  | **0** |  | **14,600** |  | **18,800** |  |
| **Ending cash balance** |  | **$14,600** |  | **$18,800** |  | **$12,500** |  |
|  |  |  |  |  |  |  |  |

**Demonstration Problem 1-1 Workpaper, part a.**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **2015** |  |  **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| ***No.*** |  | ***Cash*** | ***+*** | ***Land*** | ***=*** | ***Liab.*** | ***+*** | ***C. Stk.*** | **+** | ***Ret. Earn.*** |  |  |  |  |  |  |  |  |  |
| **Beg. bal.** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **1** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **2** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **3** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **4** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **5** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **Totals** |  | **14,600** | **+** |  | **=** | **5,000** | **+** | **9,000** | **+** | **600** |  | **4,000** | **–** | **2,900** | **=** | **1,100** |  |  **14,600 NC** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **2016** |  | **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| ***No.*** |  | ***Cash*** | ***+*** | ***Land*** | ***=*** | ***Liab.*** | ***+*** | ***C. Stk.*** | **+** | ***Ret. Earn.*** |  |  |  |  |  |  |  |  |  |
| **Beg. bal.** |  | **14,600** | **+** |  | **=** | **5,000** | **+** | **9,000** | **+** | **600** |  |  | **–** |  | **=** |  |  |  |  |
| **1** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **2** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **3** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **4** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **5** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **Totals** |  | **18,800** | **+** |  | **=** | **3,000** | **+** | **13,500** | **+** | **2,300** |  | **6,700** | **–** | **4,300** | **=** | **2,400** |  |  **4,200 NC** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| **2017** |  | **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| ***No.*** |  | ***Cash*** | ***+*** | ***Land*** | ***=*** | ***Liab.*** | ***+*** | ***C. Stk.*** | **+** | ***Ret. Earn.*** |  |  |  |  |  |  |  |  |  |
| **Beg. bal.** |  | **18,800** | **+** |  | **=** | **3,000** | **+** | **13,500** | **+** | **2,300** |  |  | **–** |  | **=** |  |  |  |  |
| **1** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **2** |  |  | **+** |  | **=** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **3** |  |  | **+** |  | **+** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **4** |  |  | **+** |  | **+** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **5** |  |  | **+** |  | **+** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **6** |  |  | **+** |  | **+** |  | **+** |  | **+** |  |  |  | **–** |  | **=** |  |  |  |  |
| **Totals** |  | **12,500** | **+** | **9,000** | **+** | **4,000** | **+** | **16,000** | **+** | **1,500** |  | **7,400** | **–** | **7,900** | **=** | **(500)** |  |  **(6,300) NC** |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

**Demonstration Problem 1-1 Workpaper, part b.**

|  |
| --- |
| **Computer Services Company** |
| **Income Statements** |
| **For the Years Ended December 31,** |  | **2015** |  | **2016** |  | **2017** |  |
| **Services revenue** |  |  |  |  |  |  |  |
| **Operating expenses** |  |  |  |  |  |  |  |
| **Net income (loss)** |  | **$1,100** |  | **$2,400** |  | **$( 500)** |  |
|  |  |  |  |  |  |  |  |
| **Statements of Changes in Stockholders’ Equity** |
| **Beginning common stock** |  | **$ 0** |  | **$ 9,000** |  | **$13,500** |  |
| **Plus: Common stock issued** |  |  |  |  |  |  |  |
| **Ending common stock** |  |  |  |  |  |  |  |
| **Beginning retained earnings** |  | **0** |  | **600** |  | **2,300** |  |
| **Plus: Net income (loss)** |  |  |  |  |  |  |  |
| **Less: Dividends** |  |  |  |  |  |  |  |
| **Ending retained earnings** |  |  |  |  |  |  |  |
| **Total stockholders’ equity** |  | **$9,600** |  | **$15,800** |  | **$17,500** |  |
|  |  |  |  |  |  |  |  |
| **Balance Sheets at December 31** |
| **Assets** |  |  |  |  |  |  |  |
|  **Cash** |  |  |  |  |  |  |  |
|  **Land** |  |  |  |  |  |  |  |
| **Total assets** |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
| **Liabilities** |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
| **Stockholders’ equity** |  |  |  |  |  |  |  |
|  **Common stock** |  |  |  |  |  |  |  |
|  **Retained earnings** |  |  |  |  |  |  |  |
| **Total stockholders’ equity** |  |  |  |  |  |  |  |
| **Total liabilities and stockholders’ equity** |  | **$14,600** |  | **$18,800** |  | **$21,500** |  |
|  |  |  |  |  |  |  |  |
| **Statements of Cash Flows** |
| **Cash flows from operating activities** |  |  |  |  |  |  |  |
|  **Cash inflows from revenue** |  | **$ 4,000** |  | **$ 6,700** |  | **$ 7,400** |  |
|  **Cash outflows for operating expenses** |  |  |  |  |  |  |  |
| **Net cash flow from operating activities** |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
| **Cash flow from investing activities** |  |  |  |  |  |  |  |
|  **Cash outflow for land** |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
| **Cash flows from financing activities** |  |  |  |  |  |  |  |
|  **Cash inflows from borrowing** |  |  |  |  |  |  |  |
|  **Cash outflows to reduce debt** |  |  |  |  |  |  |  |
|  **Cash inflows from stock issues** |  |  |  |  |  |  |  |
|  **Cash outflows for dividends** |  |  |  |  |  |  |  |
| **Net cash flows from financing activities** |  |  |  |  |  |  |  |
|  |  |  |  |  |  |  |  |
| **Net change in cash** |  | **14,600** |  | **4,200** |  |  |  |
| **Beginning cash balance** |  |  |  |  |  | **18,800** |  |
| **Ending cash balance** |  |  |  |  |  | **$12,500** |  |
|  |  |  |  |  |  |  |  |

### Quiz Questions for Chapter 1

**The following information pertains to the next three questions**. At the beginning of 2016, X Company had assets of $600, liabilities of $300, and common stock of $100. During 2016 the company earned revenue of $750, incurred expenses of $500, and paid dividends of $100. All transactions were cash transactions.

1. The amount of net income reported on the 2016 income statement would be

a. $250.

b. $300.

c. $150.

d. none of the above.

2. The amount of retained earnings reported on the December 31, 2016 balance sheet would be

a. $150.

b. $250.

c. $200.

d. none of the above.

3. The amount of total assets reported on the December 31, 2016 balance sheet would be

a. $750.

b. $600.

c. $850.

d. $100.

4. P Company borrowed $400 cash from Citizens Bank. As a result of this transaction, P Company’s

a. assets would decrease by $400.

b. liabilities would increase by $400.

c. equity would increase by $400.

d. expenses would increase by $400.

**The following information pertains to the next two questions.**  ABC Company borrowed $600 from Sun Bank and used $500 of this money to purchase land.

5. XYZ's total assets would increase by

a. $1,100.

b. $ 500.

c. $ 600.

d. $ 100.

6. The statement of cash flows for ABC Company would report

a. an inflow of $600 from operating activities.

b. an outflow of $500 for investing activities.

c. an inflow of $500 from financing activities.

d. an outflow of $500 for operating activities.

7. Select the correct statement from the choices listed below.

a. Revenue is a decrease in assets resulting from operating activities.

b. Dividends are decreases in assets incurred for the purpose of producing revenue.

c. A company incurs expenses when it borrows money.

d. Net income is an increase in equity resulting primarily from operating activities.

8. If revenue exceeds expenses, there are no dividends, and total liabilities remain unchanged, then

a. Equity will decrease.

b. Net assets will increase.

c. Total assets will decrease.

d. a and c.

**The following information pertains to the next two questions.** Company A paid $20,000 cash to buy land from Company B.

9. Select the statement that is true.

a. Total liabilities of Company B would increase.

b. Total assets of Company A would be unaffected.

c. Company A's equity would increase.

d. None of the above.

10. Select the statement that is true.

a. Company A would have a cash outflow from investing activities.

b. Company B would have a cash inflow from investing activities.

c. The balance in the cash account on Company A's books would decrease, while the balance in the cash account on Company B’s books would increase.

d. All of the above statements are true.

11. Revenue is less than expenses. If liabilities and common stock were unchanged, then

a. cash flows from operating activities were greater than cash flows from investing activities.

b. retained earnings were less than net income during the period.

c. total assets decreased.

d. the company must have purchased assets with cash.

12. Among other items, the balance sheet of XYZ Company reports retained earnings of $60,000 and total liabilities of $40,000. Based on this information alone, you would know that

a. XYZ Company has enough cash to pay off its liabilities.

b. since the company’s inception, the total amount of net income exceeded total dividends by at least $60,000.

c. net assets of the company amounted to $20,000.

d. total assets amounted to $100,000.

13. The Southern Company began the accounting period with assets of $600, common stock of $200, and retained earnings of $250. During the period, revenue was $300, expenses were $200, and dividends were $50. Common stock was unchanged during the accounting period. Liabilities decreased by $100. Based on this information,

a. net income amounted to $50.

b. total assets at the end of the period were $550.

c. retained earnings at the end of the period amounted to $350.

d. liabilities at the end of the period amounted to $100.

14. Which of the following illustrates how a cash dividend affects a company’s financial statements?

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Balance Sheet** |  | **Income Statement** |  | **Statement of** |  |
|  |  | **Assets** | **=** | **Liab.** | **+** | **Equity** |  | **Rev.** |  | **Exp.** | **=** | **Net Inc.** |  | **Cash Flow** |  |
| a. |  | + |  | n/a |  | + |  | n/a |  | n/a |  | n/a |  | + FA |  |
| b. |  | + |  | n/a |  | + |  | + |  | n/a |  | + |  | + OA |  |
| c. |  | - |  | n/a |  | - |  | n/a |  | + |  | - |  | - OA |  |
| d. |  | - |  | n/a |  | - |  | n/a |  | n/a |  | n/a |  | - FA |  |
|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |

### 15. Which of the following accounts is not closed at the end of the accounting period?

a. Retained Earnings

b. Operating Expenses

c. Dividends

d. Service Revenue

### Quiz Answers

|  |  |
| --- | --- |
| Question | Answer |
| 1 | A |
| 2 | D |
| 3 | A |
| 4 | B |
| 5 | C |
| 6 | B |
| 7 | D |
| 8 | B |
| 9 | B |
| 10 | D |
| 11 | C |
| 12 | D |
| 13 | B |
| 14 | D |
| 15 | A |

### Summary Outline of a Lesson Plan for Chapter 1

**(Horizontal Financial Statements Model Approach)**

1. **Use the problem-based learning case, “Ask Me Anything,” to introduce financial statements to students.**

 **II. Create a collaborative experience where students reach consensus on their questions.** Have each group select a spokesperson.

 **III. Briefly introduce the basic financial statements.**  Introduce: 1) the balance sheet, 2) the income statement, and 3) the statement of cash flows.

 **IV. Use student input to demonstrate the usefulness of financial statement information.** Ask the group spokespersons to share the questions their group would like to have the accountant answer. Identify information that would or would not appear in financial statements. Students should learn to name three financial statements and to describe the specific elements that appear in each statement.

1. **Distribute copies of the Self-Study Review problem at the end of Chapter 1 in the text**. Point out that the answers to this problem are included in the text and narrated slides are also available online for future reference. Encourage students to listen and work along with you as you work this problem, rather than focus on taking notes regarding what you say.
2. **Create a horizontal financial statements model for the Self-Study Review Problem**. Show students how to record business events directly into a set of financial statements.

**VII. This is an excellent time to mention the closing process without getting into procedural detail.** You can point out that the revenue and expense entries actually represent the combination of 2 entries – the transaction entry and the closing entry.

 **VIII. Actively involve the students in learning**. After working through the Self-Study Review Problem, consider having the students work the Demonstration Problem 1-1 in this chapter of the Instructor’s Manual.

### Summary Outline of a Lesson Plan for Chapter 1

**(Equation Approach)**

1. **Distribute copies of the Self-Study Review Problem**.

 **II.**  **Define assets**.

 **III.** **Introduce the accounting equation.**

|  |  |  |
| --- | --- | --- |
| Assets | = | Claims |

 **IV. Use the self –study review problem to introduce new terms and to elaborate on the interrelationships represented by the accounting equation.** Discuss the difference between ***asset source transactions, asset use transactions***, and ***asset exchange transactions***.

 **V. Introduce the horizontal financial statements model**.

 **VI.**  **Actively involve the students in learning**.

After explaining the Self-Study Review problem, ask the students to complete Exercise 1-11B or the Demonstration problem (at the end of this section of the instructor’s manual) on their own. You will probably need to make copies of whichever item you ask them to complete, since not all students will bring their text to class every day.

 **VII. Introduce financial statements.**

**VIII. Fill in the gaps.**  You will find additional terms and concepts covered in the text but not in the teaching notes.

 **IX. Enrichment.** Appendix B contains excerpts from the Target 10-K report. It helps students to see a ‘real world’ example of what is being covered in class. While they are not yet ready to fully analyze financial statements as complex as those presented in this Appendix, you can point out the fact that the 4 financial statements are included here and discuss how they tie to the example that has been covered in class.

1. Revenues can also result from activities that decrease liabilities. Revenue recognition within this context requires an understanding of deferrals. Deferrals are introduced in Chapter 2. Within the context of cash basis accounting, which is the underlying assumption for Chapter 1, revenue can be defined simply as an increase in assets from providing services and expenses as decreases in assets from revenue-producing activities. These definitions will be expanded as accrual accounting topics are gradually introduced. [↑](#footnote-ref-1)