Chapter 1: Business Decisions and Financial Accounting

Summary

This chapter focuses on the key financial reports that business people rely on when evaluating a company's performance. This chapter introduces the basic elements and uses of accounting, and introduces the focus company Pizza Palace as an example. Pizza Palace will be used as an example throughout the textbook. After outlining the origin of Pizza Palace, the chapter describes the purpose, set-up and content of the four basic financial statements. Then, the chapter begins to explore the fundamental role that accounting information plays in financial statement users' decisions.

Where we are

Chapter 1 introduces the basic financial statements. Chapters 2 and 3 will discuss the balance sheet and income statement, respectively, and introduce transaction analysis and the mechanics of debits and credits. Chapter 4 explores more advanced accruals while Chapter 5 will introduce financial statement ratios. Later chapters discuss individual areas of the balance sheet and related income statement accounts.

What's unique

This chapter introduces accounting by explaining the fundamental role that it plays in business. Students will be intrigued by the Pizza Palace example provided as some of the accounting decisions involved in starting a business are presented. The mechanics of debits and credits, and the role of organizations and securities legislation are saved for later.

Learning objectives

***U*nderstand** the business
LO1 Describe various organizational forms and types of business decision makers.
***S*tudy** the accounting methods
LO2 Describe the purpose, structure, and content of the four basic financial statements.
***E*valuate** the results.
LO3 Explain how financial statements are used by decision makers. LO4 Describe factors that contribute to useful financial statements.
***R*eview** the chapter

Chapter Outline

1. UNDERSTAND THE BUSINESSES
    a. Organizational Forms
        i. Sole Proprietorship
        ii. Partnership
        iii. Corporation
    b. Accounting for Business Decisions
2. STUDY THE ACCOUNTING METHODS
    a. The Basic Accounting Equation
        i. Assets
        ii. Liabilities
        iii. Shareholders' Equity
            1. Revenues
            2. Expenses
            3. Net Income
    b. Financial Statements
        i. The Income Statement
        ii. The Statement of Retained Earnings
        iii. The Balance Sheet
        iv. The Statement of Cash Flows
            1. Operating
            2. Investing

            3. Financing
    c. Notes to the Financial Statements
    d. Relationships among the Financial Statements
3. EVALUATE THE RESULTS
    a. Using Financial Statements
    b. Useful Financial Information
        i. Generally Accepted Accounting Principles (GAAP)
        ii. Ethical Conduct
        iii. Epilogue for Pizza Palace
4. REVIEW THE CHAPTER
    a. Demonstration Case

Lecture Notes

Topic	Time estimate
I. Why is accounting Important?	15-20 minutes
II. The Basic Accounting Equation	20-25 minutes
II. The Income Statement	15-20 minutes
III. The Statement of Retained Earnings	10-15 minutes
IV. The Balance Sheet	20-25 minutes
V. The Statement of Cash Flows	15-20 minutes
VI. Aspects of financial statements	10-15 minutes
VII. Why is accounting important? – Recap	15-20 minutes

I. Why is accounting important? (15-20 minutes)

A. Most students enter an accounting class with some trepidation about taking such a "difficult" course. It is good to dispel that at the beginning of the first class, and build their interest by dramatizing a real-life example. Announce: **Pizza**

Teaching Tip

Begin teaching the course with questions, not answers. At the beginning of the first day, students are fresh and ready to learn. Use this valuable time to motivate them – explain why you find accounting interesting and important. Later on in the course, you'll have many hours of classroom time to teach the mechanics of debits, credits, deferrals, accruals, ratios and the like.

Try saving the syllabus and course policies for the *end* of the first class. If any of your students are solely interested in your attendance or homework policies, they will have to sit, listen, and wait.

Palace, a start up pizza restaurant.

B. How do you start a business? A few flippant questions usually build students' interest:

– What planning do you need to do?

– What initial decisions need to be made?

– How does a business make money (i.e. profit)?

C. Dramatize the issue: "Suppose that you are a wealthy investor considering investing in Pizza Palace. Why would you invest?

D. Further dramatize the issue: Does Pizza Palace need investors? What would they get from you the investor? What would the investor get from Pizza Palace? What is the difference between investors and creditors?

E. In this course, we will learn all about the accounting behind operating a business, where the money to start a business comes from, where profits and net losses come from, etc.

F. Accounting is an information system to capture the activities affecting a business's financial condition and performance and then report the results to decision makers, both inside and outside the organization. [**Exhibit 1.1**]

– Who uses this information system? Internally and externally.

II. The Basic Accounting Equation

A. Even if they memorize the accounting equation, students often have trouble understanding how assets, liabilities and shareholders' equity interrelate. Therefore, personalize the equation by introducing your own, "fictionalized" balance sheet.

B. "My house [expensive neighborhood], my Ferrari, my other Ferrari, and my investment portfolio are worth $10 million. I owed the bank $4 million on my mortgage. How much am I worth?"

– Write the numbers on the board, like so:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Net Worth</u>
$10 million	=	$4 million	+	?

– Students will immediately respond with "$6 million." Now complete the chart.

C. "Now suppose that a Corporation has $10 million worth of stuff and owes $4 million to the bank. What is the company worth?"

D. Bring in this chapter's focus company, Pizza Palace, by completing the company's **accounting equation**:

Assets	=	Liabilities	+	Net Worth
$10 million	=	$4 million	+	$6 million
Assets	**=**	**Liabilities**	**+**	**Shareholders' Equity**
$58,000	=	$27,000	+	$31,000

E. Define:

- **Assets** – what a business owns
- **Liabilities** – what it owes to outsiders
- **Shareholders' Equity** – The resources left over for the owners of the company (resources owed to shareholders).
  - a. Contributed Capital – resources ($) paid in by shareholders.
  - b. Retained earnings – resources ($) earned by the company.
    - i. Explain that Retained Earnings is determined by the following:
      - a. Revenue
      - b. Expenses
      - c. Net Income
      - d. Dividends

F. **This equation must always equal** – *Resources owned by the company must equal resources owed to creditors and investors.*

- Manipulate the above net worth equation, increasing assets only. Ask the class "Is this possible?" Students will intuitively understand the concept.

III. The Income Statement (15-20 minutes)

A. Students usually have no problem grasping the concept of **income**. Start small and work your way up:

B. "If Pizza Palace makes one pizza costing 2 dollars, and sells it for 9 dollars, how much income did they earn?" – *7 dollars*. I write the equation on the board:

Revenues	**-**	**Expenses**	**=**	**Net income**
$9.00	**-**	**$2.00**	**=**	**$7.00**

C. "Now suppose that Pizza Palace makes 100 pizza's costing 2 dollars each, and sells each for 9 dollars. How much income did they earn?" - $700.00.

Revenues	-	Expenses	=	Net income
$900	-	$200.00	=	$400.00

D. *Refer to Exhibit 1.2, Pizza Palace's Income Statement.*

E. Working line-by-line:

– Heading: Who, What, When, Other.

a. "When" is a period of time, in this case, "for the month ended September 30, 2012." The income statement measures net income over a period of time. *This is different from the balance sheet, which measures financial position at a point of time – often midnight on December 31.*

> **Teaching Tip**
> The Income Statement is also called the "Statement of Operations," or the "Statement of Profit and Loss (P&L)."

– **Revenues** – increases in the company's resources, arising primarily from its operating activities.

– **Pizza Revenue** – revenues from selling goods.

– **Expenses** – the cost of doing business; decreases in a company's resources arising primarily from its operating activities.

– **Net income** = Revenues – expenses. Synonymous with **Profit** and the **"Bottom line."**

a. Conclude by reviewing Pizza Palace's income statement. What does it say?

b. The company sold *$11 thousand* worth of pizza in September 2012, and earned $2 thousand in net income on those pizza's.

F. Raise the question to the students, "What is a **net loss**?"

– A net loss results when expenses exceed revenues – it is "negative income."

IV. The Statement of Retained Earnings (10-15 minutes)

A. Be careful to motivate students with the statement of retained earnings – why is it important? (Text Exhibit 1.3)

B. Ask, "Where does net income *go*?"

– Someone might answer "the bank" – coax students to answer that it goes to the shareholders – net income *belongs* to the shareholders. The

Statement of Retained Earnings shows how much income in total has been earned and is held by the company for shareholders.

C. Define **Dividends** – payments to shareholders.

D. Net income could go in two directions:

– As cash straight to shareholders, as **Dividends.**

– Kept in the company, as **Retained Earnings**.

E. Retained Earnings Formula:

Beginning Retained Earnings	+	**Net Income**	-	**Dividends Declared**	=	**Ending Retained Earnings**

F. Drop numbers into the above formula.

Beginning Retained Earnings	+	Net Income	-	Dividends Declared	=	Ending Retained Earnings
$0	**+**	**$2,000**	**-**	**$1,000**	**=**	**$1,000**

G. Now explain what this means. Pizza Palace showed $0 in retained earnings on last year's balance sheet. The income statement added $2,000 to income. Of this, Pizza Palace paid $1,000 in dividends to shareholders. On this month's balance sheet, Pizza Palace will show $1,000 in retained earnings.

Teaching Tip

To help students understand the nature of retained earnings, ask why Pizza Palace's retained earnings increased.

Answer: Because Net income of $2000 exceeds dividends of $1000. The excess went to retained earnings.

H. Indicating the origin of each amount emphasizes that the Statement of Retained Earnings ties different financial statements together:

Beginning Retained Earnings	+	Net Income	-	Dividends Declared	=	Ending Retained Earnings
$0	**+**	**$2,000**	**-**	**$1,000**	**=**	**$1,000**
Balance Sheet, Sept. 1, 2012		**Income Statement Sept. 30, 2012**				**Balance sheet, Sept. 30, 2012**

Recall the opening discussion regarding investors and why they invest; dividends get paid to investors. And recall the net loss question from the Income statement regarding a net loss; it would be subtracted from retained earnings lowering what investors have claim to.

V. The Balance Sheet (40–50 minutes)

A. The Balance Sheet (Text Exhibit 1.4) summarizes the accounting equation at a given point in time.

   a. It lists and totals the assets, liabilities and shareholders' equity,

   b. It shows that the accounting equation works.

> **Teaching Tip**
> Avoid using synonymous terms interchangeably; for example, don't refer to the balance sheet as the statement of financial position. However, you may wish to mention that the balance sheet has alternative names.

– Explain Pizza Palace's Balance Sheet, line-by-line.

   a. Heading – **"who, what, when, other"**

      i. Emphasize the "when." The Balance Sheet measures the company's financial position at a specific point in time, often at the stroke of midnight on December 31.

   b. **Assets** – what a business owns.

      i. **Cash** – money in the bank

      ii. **Accounts Receivable** – money Pizza Palace expects to collect from customers for pizza's it has sold on credit.

      iii. **Supplies** – the cost of food and paper products on hand.

      iv. **Equipment** – the cost of ovens, tables, etc.

   c. **Liabilities** – what a business owes to outsiders.

> **Lighten Up!**
> *These boxes include light humour to try in class. They will draw students' interest and help them to remember important topics.*
>
> When discussing the balance sheet, I usually tell students that accountants don't party on New Years' Eve because this is when we prepare all of our balance sheets. You can either leave them with this misimpression until Chapter 4 (accruals) or immediately explain that this is *not* true. Most balance sheets are prepared in the weeks following December 31.

i. **Accounts Payable** – amounts owed to other companies for purchases of goods or services on credit.

ii. **Notes Payable** – similar to accounts payable, but:

a. Require interest,

b. Will usually be paid later than accounts payable, and

c. Were documented using formal contracts called "notes."

d. **Shareholders' Equity** – What is left over for owners of the company.

i. **Contributed Capital** – money invested directly in the company by its owners.

ii. **Dividends** – periodic payments to shareholders as return on their investment.

iii. **Retained Earnings** – total income and losses less any dividends paid to shareholders, since the corporation was formed. We will revisit this later.

B. *Distribute Handout 1-1*

Active Discussion Ideas - Supplementary

We define an asset as "what a business owns." In addition to the items listed above, what else does a business own? Students inevitably will comment that a company's greatest asset is its people – but can people be assets? Can a business *own* its people? Rather, a company can hold contracts to employ people – if the Blue Jays pay an advance to Vernon Wells, then his *contract* would be an asset. But Wells obviously does not *belong to* the Blue Jays.

Ask students to attempt part 1 of S1-6 (in Skills Development Cases) in pairs. This discussion-starter encourages students to rely on their intuition and the lecture discussion to construct a balance sheet, while subtly introducing issues related to asset valuation and the cost principle.

VI. The Statement of Cash Flows (15-20 minutes)

A. Now return again to question regarding a loss and ask the class, "Does a 'loss' cost you money?"

– They will invariably respond that "of course it does," or might even silently wonder why I would ask such an obvious question.

– I argue that, "maybe, maybe not!"

a. Suppose that you consistently sell Pizza's costing $2 each for $1. Will that cause you to lose money? Sure.

b. Now suppose that you have a giant factory in Toronto, churning out fresh Pizza's. You decide to close the factory and shift production to frozen pizzas from a outsourced mass production factory. The factory and all of the machinery was on your books for $50 million, and you sell it all for $10 million – a $40 million loss. Will that cost you $40 million in cash? No. In fact, at the same time as you record a $40 million loss, you will take in $10 million cash! *Here, a loss brings in positive cash flow!*

– Lesson learned: income and cash flow may move independently. This is why we need the statement of cash flows. It explains why cash changed from the beginning of the year to the end. Where did cash come from? Where did it go?

B. Basic Formula:

	Net Cash Flow from Operating Activities
+/-	Net Cash Flow from Investing Activities
+/-	Net Cash Flow from Financing Activities
	Net change in cash during the year
+	Cash at beginning of the year
	Cash at end of the year

C. Refer to the Pizza Palace Exhibit 1.5, and fill in the numbers in the above table.

	Net Cash Flow from Operating Activities	**$5,000**
+/-	Net Cash Flow from Investing Activities	**(40,000)**
+/-	Net Cash Flow from Financing Activities	**49,000**
	Net change in cash during the year	**$ 14,000**
+	Cash at beginning of the year	**0**
	Cash at end of the year	**$ 14,000**

D. Explain each category:

– **Operating activities** are cash flows directly related to earning income.

a. For Pizza Palace, this would be cash received from customers buying pizza's, cash paid to suppliers and employees making pizza's, etc. *Indicate that Pizza Palace's operations brought in $5,000 in cash flow.*

Teaching tip
Avoid providing too much detail about the cash flow statement here. Right now, students only need to know:

1. that cash flows don't necessarily coincide with net income, and
2. the three types of activities.

– **Investing activities** are cash flows related to acquiring or selling long-term assets.

a. Here you can see that Pizza Palace spent $40,000 purchasing new equipment.

– **Financing activities** are cash flows directly related to financing the company's operations, including receipts from or payments to shareholders and creditors.

a. Pizza Palace brought in $49,000 of financing from investors and the bank including dividends paid out to shareholders ($1,000 dividends paid).

E. Refer students to Self-Study Practice on text page 14.

VII. Aspects of financial statements (10-15 minutes)

A. Explain the usefulness of **comparative** financial statements.

– Indicate how the company's results progress from period to period.

B. Referring to textbook Exhibit 1.6, review the relationships between financial statements, and re-emphasize key financial statement formulas.

– The Statement of Cash Flows, Statement of Retained Earnings and Income Statement explain changes in the Balance Sheet numbers

a. Assets = Liabilities + Shareholders' Equity

– The Statement of Cash Flows explains why cash changed from the beginning-of-the-year balance sheet to the end.

a. Net operating cash flows + Net investing cash flows + Net financing cash flows = net increase in cash; Net increase in cash + beginning cash balance = ending cash balance

– The Statement of Retained Earnings explains why retained earnings changed from the beginning-of-the-year balance sheet to the end.

a. Beginning Retained Earnings + Net Income – Dividends = Ending Retained Earnings

– The Statement of Retained Earnings uses net income, found on the Income Statement.

a. Revenues – Expenses = Net Income

C. Assurance Statements – appear before financial statements in a company's annual report

- The Managements Statement of Responsibility for Financial Reporting – states Management's responsibility for financial information integrity
- The Independent Auditors' Report – states external, independent accountants have examined the financial statements

D. Notes to the Financial Statements – are provided after the financial statements. They offer information about:

- **Accounting policies** – accounting decisions made for preparing the financial statements
- **Contents included** – provides more detail about certain account balances
- **Additional information** – provides other important information not provided elsewhere. For example, the company may rent warehouse space.

E. **Generally Accepted Accounting Principles**

Public companies are required by the securities legislation to have an audit using GAAP and GAAS (Generally Accepted Auditing Standards)

- The basic rules of accounting. Set forth by:
  - a. **Canadian Institute of Chartered Accountants ("CICA") -** has primary responsibility for setting rules
  - b. **Financial Accounting Standards Board ("FASB")** – in the United States, has primary responsibility for setting rules
  - c. **International Accounting Standards Board ("IASB")** – the CICA has agreed to adopt their rules (International Financial Reporting Standards) for public companies over the next 2 years
  - d. **International Financial Reporting Standards (IFRS)** – Rules of accounting created by the IASB for international use.

F. **Refer students to the Spotlight on IFRS and ASPE section of the textbook on page 19 and emphasize the importance of IFRS.**

VIII. Why is Accounting Important? – Recap (15-20 minutes)

A. This is a great opportunity to further motivate students about the importance of accounting information and how to use financial statements.

B. The financial statements are a key source of information when external users, like creditors and investors, make decisions concerning a company.

- Explain and consider how creditors and investors might gain valuable information simply by reading the dollar amounts reported in each financial statement.
- Discuss the following points from the textbook on page 15:

a. **Creditors are mainly interested in assessing:**

i. Is the company generating enough cash to make payments on its loan? Answers to this question will come from the statement of cash flows. In particular, creditors would be interested in seeing whether operating activities are producing positive cash flows. Pizza Palace's expected net inflow of $5,000 cash from operating activities is very good for a new business.

ii. Does the company have enough assets to cover its liabilities? Answers to this question will come from comparing assets and liabilities reported on the balance sheet. Pizza Palace is expected to own slightly more than twice what it owes to creditors at September 30 (total assets of $58,000 versus total liabilities of $27,000). With $14,000 in Cash, Pizza Palace would be able to immediately pay all of its Accounts Payable and part of its Note Payable if needed.

b. **Investors expect a return on their contributions to a company.** The return may be immediate (through dividends) or long-term (through selling share certificates at a price higher than their original cost). Dividends and higher share prices are more likely if a company is profitable. As a result, investors look closely at the income statement (and statement of retained earnings) for information about the company's ability to generate profits (and distribute dividends).

Supplementary Teaching Material
The textbook briefly discusses comparative financial statements. Elaborate by presenting some five-year summary financial statements.

Handout 1-1: Balance Sheet Elements

Draw a line to match each element to its classification on the balance sheet:

Classification	**Element**
	a. Notes Payable
	b. Cash
1. Assets	c. Contributed Capital
	d. Inventories
2. Liabilities	e. Accounts Receivable
	f. Accounts Payable
3. Shareholders' Equity	g. Property, Plant & Equipment
	h. Notes Payable
	i. Retained Earnings

Handout 1-1: Balance Sheet Elements

Solution

1. b, d, e, g
2. a, f, h
3. c, i

Handout 1-2: The Statement of Cash Flows

Draw a line to match each element to its classification on the statement of cash flows:

Classification	**Element**
	a. Cash paid to suppliers and employees
1. Net cash flows from operating activities	b. Cash paid to purchase equipment and other assets
	c. Cash paid for dividends
2. Net cash flows from investing activities	d. Cash collected from customers
	e. Cash received from selling equipment and other long-term assets
3. Net cash flows from financing activities	f. Cash paid on notes payable and other financing
	g. Cash paid to suppliers and employees

Handout 1-2: The Statement of Cash Flows

Solution

1. a, d, g
2. b, e
3. c, f

Handout 1-3: Elements of the Financial Statements

Connect each item to the proper financial statement(s). Items marked with an asterisk (*) appear on two financial statements.

Financial Statement	**Item**
	a. Cash Paid for Equipment
1. Balance Sheet	b. Cash*
	c. Notes Payable
	d. Contributed Capital
2. Income Statement	e. Inventories
	f. Cost of Goods Sold
	g. Cash Received from Customers
	h. Accounts Receivable
3. Statement of Retained Earnings	i. Notes Payable
	j. Marketing Expense
	k. Property, Plant & Equipment
4. Statement of Cash Flows	l. Dividends*
	m. Net Income*

Handout 1-3: Elements of the Financial Statements

Solution

1. b, c, d, e, h, j
2. f, i, l
3. k, l
4. a, b, g, k