**Chapter 1**[1]

# Accounting for Business

**Learning Objectives**

- Explain the purpose and importance of financial information and accounting and the role they play in capital formation.
- Identify stakeholders or users and uses of accounting information.
- Define accounting information in the context of internal and external users for managerial and financial accounting, respectively.
- Identify organizations involved in regulation and oversight of accounting information.
- Explain the importance of ethics in the development and presentation of financial accounting information.
- Provide a brief description of the Securities and Exchange Commission (SEC), the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB).
- Explain generally accepted accounting principles (GAAP) and apply some accounting principles.
- Define the four basic accounting principles, four basic accounting assumptions, and two accounting constraints.
- Define and describe the three basic forms of business entity.
- Define and describe the three basic business activities.
- Define and describe the four basic financial statements and how they interrelate.
- Analyze business transactions in the framework of the accounting equation.
- Illustrate your understanding of the basic accounting equation, listing and defining the three basic classifications presented in the balance sheet.
- Explain how basic transactions are accounted for, using transaction analysis.
- Use the results from basic transaction analysis to prepare the four basic financial statements.
- Explain risk and return relations and trade-offs and compute return on assets.

[1] Acknowledgement: An earlier version of this chapter was provided to all 2014 winter term ACC201 students and all accounting faculty on January 2-3, 2014, for review notes, comments, and recommendations for improvement. I appreciate the review notes, comments, and recommendations from the 2014 winter term ACC201 students (n=13) and Professor Bob Derstine. Work on this text began in early 2014. The completion of this text was made possible through a spring 2015 sabbatical from West Chester University.

West Chester University Accounting Professors Barndt (left) and Cataldo (right) relax in early August 2011 in Benezette, Pennsylvania, while looking for elk.

Professor Barndt joined West Chester University in the fall of 2010. He served as vice president and international controller for NCO Group, Horsham, Pennsylvania. He was responsible for the financial reporting of NCO locations in Australia, the Philippines, Panama, and the United Kingdom. His extensive experience also includes, for example, serving as audit manager for Accume Partners, Moorestown, New Jersey; as vice president, chief operating officer, and chief financial officer for McGinley Mills, Inc., Easton, Pennsylvania; and as vice president of Chem Clear, Inc., Wayne, Pennsylvania.

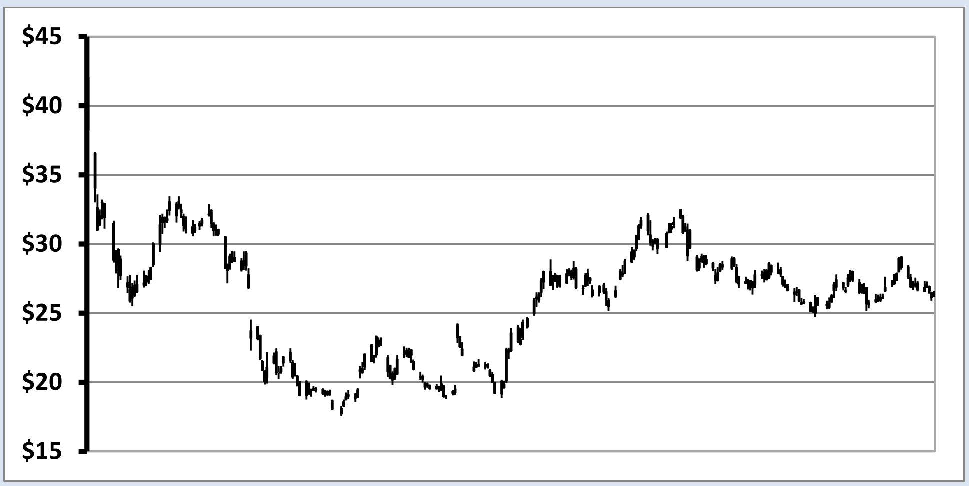
- B.S.B.A. LaSalle University
- M.B.A. LaSalle University
- Ed.D. Widener University
- C.P.A. State of Pennsylvania

Professor Cataldo joined West Chester University in the fall of 2007. He began his career in public accounting, was the chief financial officer for a small division (120 employees), worked for the California Auditor General, and was a forensic accountant, testifying in Arizona, California, Nevada, Texas and Minnesota for cases involving Ford, GM, Chrysler, Toyota, and other automobile manufacturers. He has taught at several universities, including the University of Arizona, Gonzaga, and Northeastern. His publications have appeared in *National Tax Journal*, *Tax Notes*, *Journal of Accountancy*, *Strategic Finance*, and many others. He has been quoted by the *Wall Street Journal* and his research has been used by the *Securities and Exchange Commission* in Court.

- B.S.B.A. Accounting/Finance University of Arizona
- M.Acc. Taxation University of Arizona
- Ph.D. Virginia Polytechnic Institute and State University
- C.P.A. State of Arizona
- C.M.A. Institute of Management Accountants
- C.G.M.A. American Institute of Certified Public Accountants

**Accounting for Facebook, the Initial Public Offering and Capital Formation**
Facebook[2] (NASDAQ: FB) held their initial public offering (IPO) on May 18, 2012.[3] More than 500 million shares traded on the day of the IPO, with an opening price of $42.05, a high of $45, a low of $38, and a closing price of $38.23 per share.

The Facebook IPO provides a contemporary example of how capital markets are used to raise capital to finance growth and operations. The price per share of Facebook stock did (eventually) rise above its IPO high of $45 per share.[4] Facebook's price per share, for the first year, is summarized in the below graph.




[2] The website for Facebook is located at https://www.facebook.com/.
[3] An IPO is the first sale of stock by a private company to the public, usually issued by smaller, younger companies seeking the capital to expand, but IPOs can also be done by large privately owned companies looking to become publicly traded. The issuer is assisted by an underwriting firm, which helps it determine what type of security to issue (common or preferred stock), the best offering price and the timing of the IPO. An IPO is also referred to as a *public offering*.
[4] A possible explanation for the short-term decline in the price per share for Facebook stock is the highly publicized "unlocking" of restrictions in the sale of an additional supply of shares, which occurred prior to the 2012 calendar year end.

Financial information facilitates, among other things, capital formation (e.g., Facebook and Twitter). Capitalism is dependent on economic resources to fund the expansion of these firms and other firms in growth industries. Financial information is used to assist investors and see to it that economic resources are deployed to their *highest and best use*.

**Accounting Information**

Accounting represents the financial component of a broader information and measurement system. Accounting systems identify, record, summarize and communicate relevant, reliable, and consistent financial and economic events-based transactions and information about a firm's business activities.

***Identify → Record → Summarize → Communicate***

While the accounting process includes the early stages of recordkeeping or bookkeeping, it extends beyond the mere recording of transactions and events, including analysis and interpretation. However, before you are able to effectively and efficiently analyze and interpret accounting and financial information, you must master the mechanical aspects of the recordkeeping or bookkeeping process. This introductory course in financial accounting will provide this foundation.

Accounting is, frequently, referred to as the *language of business*. Users of this language include two broad groups:

- **External** users - include members of the board of directors, shareholders or investors, financial institutions or potential creditors, customers, suppliers, regulators, attorneys, stock brokers, and the financial and general press. *Financial* accounting serves external users with financial statements.
- **Internal** users - include those directly involved in the day-to-day operations of the firm. *Managerial* accounting focuses on the needs and forms of accounting and financial information used to facilitate the internal decision-making process.

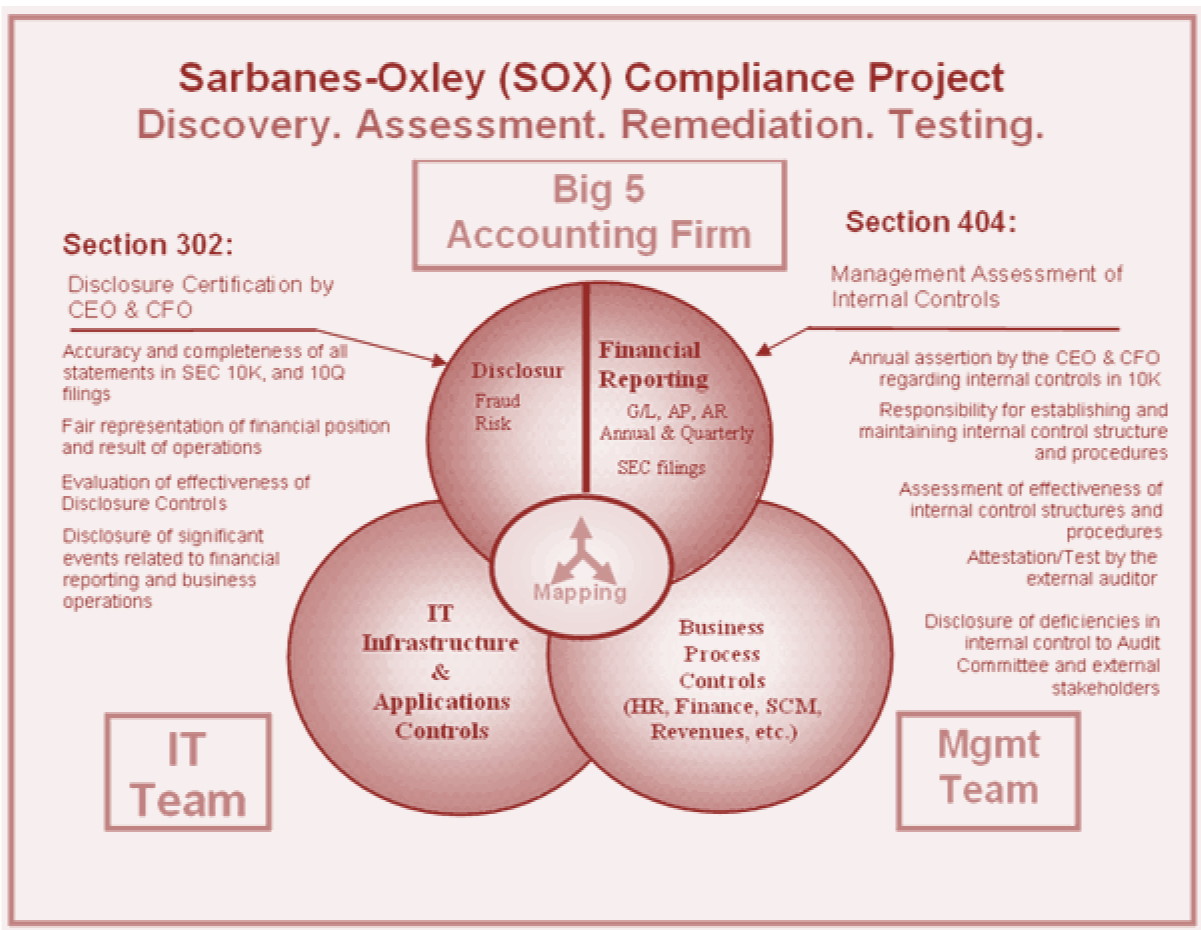
| **External** users | **Internal** users |
|---|---|
| • *Creditors or lenders* | • *Board of directors* |
| • *Stock or shareholders* | • *Executives* |
| • *Governments* | • *Managers* |
| • *Consumer groups* | • *Controllers* |
| • *External auditors* | • *Internal auditors* |
| • *Suppliers* | • *Employees* |
| • *Customers* | |

### Securities and Exchange Commission[5]

The Securities and Exchange Commission (SEC) was established in response to the stock market crash of 1929 and the *Great Depression*. Formed through the Securities Exchange Acts of 1933 and 1934, the SEC has oversight authority over firms listed on major stock exchanges (e.g., the New York Stock Exchange (NYSE)) and required to file audited financial statements with them.

### Sarbanes-Oxley

The Sarbanes-Oxley (SOX) Act was passed by Congress (2002) as a reaction to highly publicized stock or capital markets audit failures (e.g., Enron and WorldCom). SOX was




designed to legislatively require greater transparency, accountability, and the verification of internal controls and internal control effectiveness. Certified Public Accountants (CPAs) or auditors verify the effectiveness of internal controls.

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[5] The website for the SEC is located at [http://www.sec.gov/](http://www.sec.gov/).

**American Institute of Certified Public Accountants**[6]

The American Institute of Certified Public Accountants (AICPA) is the national professional organization of CPAs and has been instrumental in the development of generally accepted accounting principles (GAAP). The AICPA appointed the Committee on Accounting Procedure (CAP) in 1939. This committee of practicing CPAs issued 51 Accounting Research Bulletins (ARBs) through 1959. The Accounting Principles Board (APB) issued 31 APB Opinions from 1959 to 1973.

**Financial Accounting Standards Board**[7]

The Financial Accounting Standards Board (FASB; 1973-) is the umbrella organization appointed and answering to the Financial Accounting Foundation (FAF) and the Financial Accounting Standards Advisory Council (FASAC). FASB members need not be CPAs. The FASB issues standards and interpretations, financial accounting concepts, technical bulletins, and Emerging Issues Task Force (EITF) statements. The FASB is the accounting profession's self-regulatory body, charged with the responsibility of establishing and maintaining generally accepted accounting principles.

**The Importance of Ethics**

While Enron (Andrew Fastow and Jeffrey Skilling) and WorldCom (Bernard Ebbers) remain some of the most highly publicized cases of fraud for publicly traded stocks, the most recent, highly publicized failure of ethical behavior is, perhaps, the case of Bernard Madoff of Madoff Investment Securities.

Initially, the Madoff fraud was estimated to have resulted in losses of $65 billion in a Ponzi-scheme-based fraud. However, later estimates suggest that investors lost approximately $20 billion in principal. Recoveries remain in process and have reduced this amount.

**Generally Accepted Accounting Principles**

Generally accepted accounting principles (GAAP) provide the concepts and rules governing financial accounting practice. These principles have changed or been modified, over time and in response to the demands of users of financial accounting information. The objective of GAAP is to provide financial information that is *relevant*, *reliable*, and *comparable*.

The SEC has the legal authority over GAAP, but has delegated this task to the FASB, a private-sector group that sets both broad and specific principles. The accounting profession, therefore, self-regulates, though the SEC can challenge any positions taken by this self-regulatory body.

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[6] The website for the AICPA is located at http://www.aicpa.org/.

[7] The website for the FASB is located at http://www.fasb.org/facts/index.shtml.

**International Accounting Standards Board**[8]

The International Accounting Standards Board (IASB) represents a restructured International Accounting Standards Committee (IASC). The former will work toward the development of a single set of high-quality global accounting standards. The latter was established in 1973, to harmonize international accounting standards. The IASB is charged with the development of International Financial Reporting Standards (IFRS).

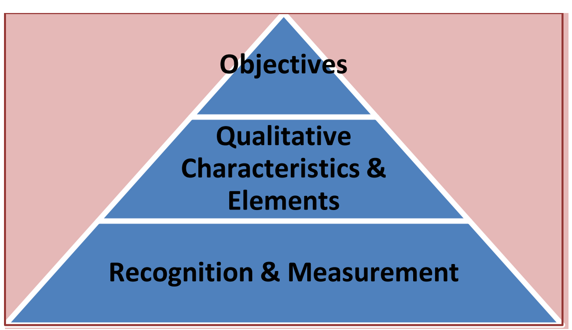
The objective of harmonization is to be able to use a single set of financial statements in all financial markets. The differences between U.S. GAAP and IFRS continue to fade, as the FASB and the IASB pursue *harmonization* and *convergence* to achieve a single set of standards for global use. Non-U.S. SEC registrants are no longer required to incur the additional costs to reconcile IRFS to U.S. GAAP. U.S. GAAP is still required for U.S. SEC registrants.

Large publicly traded U.S. companies might have to adopt IFRS as early as 2015. Smaller companies are likely to follow at some later date. Early adoption is permitted for large multinationals.

**Conceptual Framework and Convergence**

The FASB and IASB are attempting to integrate or converge and enhance the conceptual framework, which consists of:

- *Objectives* – to provide information useful to all stakeholders (e.g., investors and creditors).
- *Qualitative Characteristics* – to require information that is relevant, reliable, and comparable.
- *Elements* – to define financial statement items or components.
- *Recognition and Measurement* – to set criteria to be met by financial statement items or components, and how they should be measured.




[8] The website for the IASB is located at http://www.iasb.org/Home.htm.

A more fully developed variation of the above is developed and introduced in most intermediate-level financial accounting texts. A comparable supplement to the *Qualitative Characteristics* of accounting information is provided in **Appendix A** to this chapter.

**Accounting Principles and Accounting Assumptions**

There are two classifications of accounting principles and assumptions. General principles include basic assumptions, concepts and guidelines used when preparing financial statements, originating from long-used accounting practices. Specific principles include detailed rules used to report business transactions and events, frequently arising from rulings of authoritative groups.

**Accounting Principles**

There are four basic accounting principles:

**Accounting Principles**

1. Measurement, Cost or ***Historical Cost***
2. Revenue Recognition
3. Expense Recognition or ***Matching***
4. Full Disclosure

1. The *measurement principle* (or *historical cost principle*) is based on the presumption that accounting information is based on actual or historical cost. While these measures might, subsequently, be adjusted to market value, measures used originate from the cash or cash value of an item given up or received in the exchange transaction. Historical cost is *reliable*, *verifiable* and *objective*.
   For example, if a firm pays $500 for furniture, the purchase will be recorded at $500. The fair market value of the furniture is not relevant. The check was written for $500, and this measure is reliable, verifiable and objective.
2. The *revenue recognition principle* provides guidance with respect to the timing of recording revenue (sales) from selling products or services. Recognizing revenue too early might make a firm appear to be more profitable than it really is. Recognizing revenue too late might make a firm appear to be less profitable than it really is. There are three very important concepts to keep in mind with respect to the revenue recognition principle:
   - Revenue is recognized when earned. The earnings process is normally completed when services are performed or ownership is transferred from a seller to the buyer.
   - Proceeds from sales need not be in cash. Credit sales or sales on account represent alternatives to cash sales, and revenue from these sales are considered recognized and earned on the date of the sale.
   - Revenue is measured as cash received plus the cash value of other items received. So a sale that includes a down payment plus a future promise to pay or a balance due at some later date is recognized and earned on the date of the sale.

3. The *expense recognition principle* (or *matching principle*) requires that firms record expenses incurred to generate revenues recognized. These revenues and expenses are *"matched"* to the period in which they occurred.
4. The *full disclosure principle* requires that a firm report sufficient details, supporting the financial statements, to the extent that this additional information might have an impact on financial statement "user" decisions. Typically, these disclosures appear in the notes or footnotes to the financial statements.

**Accounting Assumptions**

There are four basic accounting assumptions:

| **Accounting Assumptions** |
| --- |
| 1. Going-Concern |
| 2. Monetary Unit |
| 3. Time Period or ***Periodicity*** |
| 4. Business Entity |

1. The *going-concern assumption* presumes that the business will continue to operate. An alternative assumption would be that the firm is not going to continue to operate and/or must be liquidated. Under the going-concern assumption, property continues to be reported at historical cost. If this assumption cannot be made or is not reasonable, property would have to be revalued, perhaps at liquidation value.
2. The *monetary unit assumption* provides for the expression of economic transactions and events in money or monetary units. This would include the dollar in the U.S., the peso in Mexico, and so on.
3. The *time period* (or *periodicity*) *assumption* provides for the production of financial statements and useful financial reports in months, quarters, semi-annual and annual periods.
4. The *business entity assumption* provides for separation between a business entity and its owners. Generally, there are three legal forms for an entity:

| **Forms of Business Entity** |
| --- |
| 1. Sole Proprietorship |
| 2. Partnership |
| 3. Corporation |

- A *sole proprietorship* or proprietorship is a business owned by one person. For tax and liability purposes, the sole proprietor and the business are viewed as a single entity, so no special legal requirements must be met to start a proprietorship. A disadvantage associated with this form of business is its unlimited liability. The sole proprietorship is a separate accounting entity.
- A *partnership* is a business owned by two or more persons, called partners. Partners are jointly and severally liable for partnership obligations, and, usually, involve the development and agreement to a legal document called a partnership

agreement, detailing how partnership profits and losses are to be shared by the partners. A partnership, like a sole proprietorship, is not an entity legally separate from the owners/partners, so the same disadvantage exist with respect to unlimited liability. Three different types of partnerships include:

**Three Types of Partnership**

1. General and Limited Partnership
2. Limited Liability Partnership
3. Limited Liability Company

   a. General and Limited partnerships (LPs) distinguish between and have both general and limited partners. Limited partners are "limited" with respect to liability. They can only lose their investment, plus any assessments provided for in the partnership agreement. They are not involved in managing the partnership. General partners manage the partnership, so their liability is unlimited.
   b. Limited liability partnerships (LLPs) restrict partner liabilities to their own actions and those acts conducted by persons under their control, protecting innocent partners from the negligence of other partners. All partners remain responsible for partnership debts.
   c. Limited liability companies (LLCs) provide for the limited liability associated with the corporate form of organization, but the tax treatment associated with a partnership or sole proprietorship.

- A *corporation* is a business legally separate from its owners. Corporations act through their managers, legal agents considered to remain separate from owners. Owners of corporations are also known as shareholder or stockholders.

Stockholders have limited liability, and are not held liable for corporate actions or debts. This is the primary advantage associated with the corporate form of business entity. Disadvantages include double taxation. There are two types of corporations:

**Two Types of Corporation**

1. C Corporation (the focus of this and most financial accounting courses)
2. S Corporation

Corporate income is taxed at the corporate level, in the case of a C (or subchapter C) corporation. Dividends paid to stockholders are taxed, again, at the individual level. In contrast, an S (or subchapter S) corporation is not a taxpaying entity, where shareholders report their share of corporate income on their personal or individual tax return.

Corporate ownership is represented by shares or stock. If a corporation has only one class of stock, it is referred to as common stock.

**Accounting Constraints**
There are two basic accounting constraints:

| **Accounting Constraints** |
|---|
| 1. Materiality |
| 2. Cost-Benefit |

1. The *materiality constraint* takes the relative importance and size of a measure into consideration. Only information likely to influence a reasonable user's decision-making process need be disclosed. This is a matter of professional judgment and experience, where it is desirable to avoid generating "noise" or information likely to be insignificant or immaterial.
2. The *cost-beneficial constraint* considers the cost or producing information with the benefits likely to result from its generation and disclosure. The cost should not exceed the benefit.

Some of the basic attributes of proprietorships, partnerships and corporations are summarized below:

| **Attributes** | **Sole Proprietor** or **Proprietorship** | **General Partnership** | **Subchapter C Corporation** |
|---|---|---|---|
| Separate Accounting Entity | Yes | Yes | Yes |
| Single Owner | Yes | No | Yes |
| Entity Taxed | No | No | Yes |
| Limited Liability | No | No | Yes |
| Separate Legal Entity | No | No | Yes |
| Unlimited Life | No | No | Yes |
| U.S. Federal Tax Forms | Form 1040 Schedule C or F | Form 1065 | Form 1120 |

**Basic Financial Statements**[9]
The four basic financial statements, in order of preparation, include:

(1) **Income Statement** – reports revenues less expenses over a period of time.
(2) **Statement of Retained Earnings** – reports how retained earnings change over a period of time.
(3) **Balance Sheet** – reports the firm's financial position at a point in time.
(4) **Statement of Cash Flows** – report sources and uses of cash over a period of time.

**Basic Business Activities**
As you progress through this text and accounting and business coursework you will realize that there are three basic business activities, classified as

(1) **Operating** – involving the use of resources for short-term or current operations.
(2) **Investing** – involving the use of long-term or noncurrent assets to achieve both short-term and long-term (or current and noncurrent) operating goals and objectives.
(3) **Financing** – involving the use debt (and financial leverage) and equity to achieve both short-term and long-term (or current and noncurrent) goals and objectives.

The above framework will be most apparent in the framework and design of the statement of cash flows, the basic format for which is introduced later in this chapter.

**The Basic Accounting Equation**
Introductory and undergraduate accounting courses place considerable emphasis on the development of skills used to analyze increasingly complex business activities and transactions and their mechanical placement within the framework of the basic accounting equation, as follows:

$$\boxed{\text{Assets} = \text{Liabilities} + \text{Equity}} \text{ or } \boxed{A = L + E}$$

**Assets** represent economic resources that a firm owns or controls. Assets are expected to generate future returns or benefits to the firm and its owners. *Receivables*

[9] Many examples of these and other financial statements and supporting schedules can be found on the Internet. For example, you can go to the Ford Motor Company (NYSE: F) website located at http://www.ford.com/ and click the investors link located at http://www.ford.com/about-ford/investor-relations to identify and review their latest annual report. The annual report provides basic financial information, but is packaged, also, as a marketing tool for the firm's stock. Alternatively, you can go directly to the SEC website and view a more detailed Form 10-K (annual financial statement) or Form 10-Q (quarterly financial statements). These documents are far more technical in format, when compared to the annual report. Still another alternative presents itself. The *Yahoo!Finance* website is available at http://finance.yahoo.com/. For example, enter the ticker symbol for Ford (F) to view the Ford Motor Company financial statements. Understand that this is a "secondary" source and the annual reports on the firm's website or on the SEC website is a "primary" source and preferable.

(or *accounts receivable*) refer to an asset expected to result in a future *inflow* of resources.

**Liabilities** represent creditors' claims on economic resources that a firm owns or controls. The firm is obligated to provide assets, products or services to these creditors at some future point in time. *Payables* (or *accounts payable*) refer to a liability expected to result in a future *outflow* of resources.

**Equity** represents owner's claims on economic resources that a firm owns or controls. Also known as *owners' equity*, *net assets* or *residual equity*, equity is equal to assets minus liabilities.

Stockholders' equity or shareholders' equity has two components:

(1) **Contributed Capital** is capital that was contributed to the firm by the shareholders. These shareholder investments are referred to as common stock.
(2) **Retained Earnings** are earnings that have not been paid out to the firm's shareholders, in the form of dividends, and have been retained for corporate growth and operations.

**Transactions Analysis**
While these operational definitions will be more fully developed in later chapters, for now, think of assets as thing you "own," liabilities are things you "owe," and the equity measure as a "plug," where given the value of assets and liabilities, you can determine the amount of equity (e.g., if assets are $10 and liabilities are $4, equity is $6). Each and every transaction, separately, uses this very mechanical and basic accounting equation or framework. Therefore, when a large number of transactions are summarized for a month, this basic accounting equation is maintained.

Assume that assets include cash, trade accounts receivable (AR; monies owed to us from sales we made to customer we also extended credit to improve our sales), supplies (a class of inventory), and property, plant and equipment (PP&E; long-lived assets like land, buildings, vehicles, and furniture). Our only liabilities are trade accounts payable (AP; monies we owe to our suppliers, when they extended credit to us to improve their sales). And our equity (or owners' equity) is everything that is not an asset (something we "own") or a liability (something we "owe"). These equities include common stock (CS), and dividends that we pay from revenues less expenses. It is very important to understand that ***common stock purchases (capital contributions) and revenues increase equity and dividends paid (capital distributions or reductions) and expenses reduce equity***.

The transactions and format that follows is a fairly common approach to introducing basic business events recorded and using the accounting equation. Assume that this is a service business or a professional services firm, as we walk through some transactions recorded using the basic accounting equation:

(1) The Soltis Corporation is formed with an initial investment of $50,000. The check comes from the owner's personal checking account to start a corporate account. The corporation issues stock to the sole shareholder in exchange for the firm's common or capital stock. There is an increase is cash, an asset, and an increase in common stock, an equity, where an increase is A, L or E is indicated with a "+" sign and a decrease is indicated with a "-" sign. The transaction is recorded below, where A = L + E or $50,000 = $0 + $50,000.

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| (1) | +$50,000 | | | | = | | + | +$50,000 | | | |

Notes:

(2) Soltis purchases supplies for a cash payment of $5,000. The transaction is recorded below, where the transaction decreases cash, an asset, and increases supplies, also an asset, by precisely the same $5,000. The new balance for A = L + E or ($45,000 + $5,000) = $0 + $50,000.

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$50,000 | | | | = | | + | +$50,000 | | | |
| (2) | -$5,000 | | +$5,000 | | = | | + | | | | |
| | +$45,000 | | +$5,000 | | = | | + | +$50,000 | | | |

Notes:

(3) Soltis purchased equipment at a cost of $35,000, again, paid for with cash. The transaction is recorded below, where the transaction decreases cash, an asset, and increases property, plant and equipment (PP&E), an asset, again, by precisely the same $35,000. The new balance for A = L + E is ($10,000 + $5,000 + $35,000) = $0 + $50,000.

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$45,000 | | +$5,000 | | = | | + | +$50,000 | | | |
| (3) | -$35,000 | | | +$35,000 | = | | + | | | | |
| | +$10,000 | | +$5,000 | +$35,000 | = | | + | +$50,000 | | | |

Notes: ______________________________

(4) Soltis purchases additional supplies, but given its declining cash balance and favorable credit worthiness, makes this purchase with a down payment of $5,000 in cash and $10,000 on credit (trade accounts payable or AP) for a $15,000 purchase. The new balance for A = L + E is ($5,000 + $20,000 + $35,000) = $10,000 + $50,000.

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$10,000 | | +$5,000 | +$35,000 | = | | + | +$50,000 | | | |
| (4) | -$5,000 | | +$15,000 | | = | +$10,000 | + | | | | |
| | +$5,000 | | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | | |

Notes: ______________________________

(5) Soltis completes professional services for an agreed upon $10,000, where the client pays the agreed upon 50% or $5,000 immediately and agrees to pay the remaining 50% or $5,000 in 30 days (trade accounts receivable or AR). The new balance for A = L + E is ($10,000 + $5,000 + $20,000 + $35,000) = $10,000 + ($50,000 + $10,000).

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$5,000 | | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | | |
| (5) | +$5,000 | +$5,000 | | | = | | + | | | +$10,000 | |
| | +$10,000 | +$5,000 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +$10,000 | |

Notes: ______________________________

(6) Soltis pays $2,500 monthly rent expense and $1,500 monthly salary expense in cash. ***Dividends (capital reductions) and expenses reduce equity.*** The new balance for A = L + E is ($6,000 + $5,000 + $20,000 + $35,000) = $10,000 + ($50,000 + $10,000 - $4,000).

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$10,000 | +$5,000 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +$10,000 | |
| (6) | -$4,000 | | | | = | | + | | | | -$4,000 |
| | +$6,000 | +$5,000 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +$10,000 | -$4,000 |

Notes: ______________________________

(7) Soltis completes professional services for an agreed upon $7,500, where the client promptly pays the entire amount in cash. In addition, the former client pays their remaining $5,000 balance (see item (5)) early. Therefore, the corporation is able to deposit $12,500 in cash, $7,500 from client B and the collection of the trade account receivable due from client A. The new balance for A = L + E is ($18,500 + $20,000 + $35,000) = $10,000 + ($50,000 + $17,500 - $4,000).

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$6,000 | +$5,000 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50.000 | | +$10,000 | -$4,000 |
| (7) | +$12,500 | -$5,000 | | | = | | + | | | +$7,500 | |
| | +$18,500 | $0 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +17,500 | -$4,000 |

Notes: ______________________________________________

(8) Soltis is having a very good first month and the firm's cash balance is very high, so management/Soltis decides to pay the $10,000 trade account payable (AP) and declare and pay a dividend of $5,000. Both reduce cash by a combined $15,000. The new balance for A = L + E is ($3,500 + $20,000 + $35,000) = $0 + ($50,000 - $5,000 + $17,500 - $4,000).

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| | +$18,500 | $0 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +17,500 | -$4,000 |
| (8) | -$15,000 | | | | = | -$10,000 | + | | -$5,000 | | |
| | +$3,500 | $0 | +$20,000 | +$35,000 | = | $0 | + | +$50,000 | -$5,000 | +$17,500 | -$4,000 |

Notes: ______________________________________________

All eight of the above transactions are summarized, complete with subtotals, in the table that follows:

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| (1) | +$50,000 | | | | = | | + | +$50,000 | | | |
| (2) | -$5,000 | | +$5,000 | | = | | + | | | | |
| | +$45,000 | | +$5,000 | | = | | + | +$50,000 | | | |
| (3) | -$35,000 | | | +$35,000 | = | | + | | | | |
| | +$10,000 | | +$5,000 | +$35,000 | = | | + | +$50,000 | | | |
| (4) | -$5,000 | | +$15,000 | | = | +$10,000 | + | | | | |
| | +$5,000 | | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | | |
| (5) | +$5,000 | +$5,000 | | | = | | + | | | +$10,000 | |
| | +$10,000 | +$5,000 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +$10,000 | |
| (6) | -$4,000 | | | | = | | + | | | | -$4,000 |
| | +$6,000 | +$5,000 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50.000 | | +$10,000 | -$4,000 |
| (7) | +$12,500 | -$5,000 | | | = | | + | | | +$7,500 | |
| | +$18,500 | $0 | +$20,000 | +$35,000 | = | +$10,000 | + | +$50,000 | | +17,500 | -$4,000 |
| (8) | -$15,000 | | | | = | -$10,000 | + | | -$5,000 | | |
| Total | +$3,500 | $0 | +$20,000 | +$35,000 | = | $0 | + | +$50,000 | -$5,000 | +$17,500 | -$4,000 |

Notes: ______________________________

Alternatively, all eight of the cash receipt and cash disbursement-based transactions are summarized, but without subtotals, in the table that follows:

| | | | | A | = | L | + | E | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | AR | Supplies | PP&E | = | AP | + | CS | Dividends | Revenues | Expenses |
| (1) | +$50,000 | | | | = | | + | +$50,000 | | | |
| (2) | -$5,000 | | +$5,000 | | = | | + | | | | |
| (3) | -$35,000 | | | +$35,000 | = | | + | | | | |
| (4) | -$5,000 | | +$15,000 | | = | +$10,000 | + | | | | |
| (5) | +$5,000 | +$5,000 | | | = | | + | | | +$10,000 | |
| (6) | -$4,000 | | | | = | | + | | | | -$4,000 |
| (7) | +$12,500 | -$5,000 | | | = | | + | | | +$7,500 | |
| (8) | -$15,000 | | | | = | -$10,000 | + | | -$5,000 | | |
| Total | +$3,500 | $0 | +$20,000 | +$35,000 | = | $0 | + | +$50,000 | -$5,000 | +$17,500 | -$4,000 |

The same fact patterns for the above transactions will also be used in Chapter 2, but the information for each transaction will be presented in some different or additional formats.

The following table converts the above format from horizontal to vertical for each account's ending balances:

| | A | = | L | + | E |
|---|---|---|---|---|---|
| Cash | $3,500 | | | | |
| AR | $0 | | | | |
| Supplies | $20,000 | | | | |
| PP&E | $35,000 | | | | |
| AP | | | $0 | | |
| CS | | | | | $50,000 |
| Dividends | | | | | -$5,000 |
| Revenues | | | | | $17,500 |
| Expenses | | | | | -$4,000 |
| | $58,500 | = | $0 | + | $58,500 |

**Basic Financial Statements**
Recall that the four basic financial statements include the **Income Statement** – reports revenues less expenses over a period of time; **Statement of Retained Earnings** – reports how retained earnings change over a period of time; **Balance Sheet** – reports the firm's financial position at a point in time; and **Statement of Cash Flows** – report sources and uses of cash over a period of time, as follows:

| | Period of Time | Point in Time |
|---|---|---|
| Income Statement | X | |
| Statement of Retained Earnings | X | |
| Balance Sheet | | X |
| Statement of Cash Flows | X | |

**Income Statement – Not in *Good Form***
Below is the basic format for the *income statement*. It is not in *good form*. Good form would include a heading with the firm's name, statement title, and period covered. Note that revenues less expenses equal net income.[10]

| | |
|---|---|
| Revenues | $17,500 |
| Expenses | $4,000 |
| Net Income | $13,500 |

[10] Net income is arrived at after income taxes, but income taxes were not included in these introductory and very basic transactions.

**Income Statement – In *Good Form***
Below is the basic format for the *income statement*. It is in *good form*. Good form includes a heading with the firm's name, statement title, and period covered.

**Soltis Corporation**
**Income Statement**
**For the Month Ended December 31, 2013**

| | |
|---|---|
| Revenues | $17,500 |
| Expenses | $4,000 |
| Net Income | $13,500 |

Revenues will include sales, interest income, rent income, and other income items. Expenses will include rent, salaries, utilities, property and other taxes, insurance, interest, and so on. Revenues and expenses can be disclosed in greater detail, but you should become familiar with this very basic format and oversimplified example in this first chapter.

**Statement of Retained Earnings – Not in *Good Form***
Below is the basic format for the *statement of retained earnings*. It is not in *good form*. Good form would include a heading with the firm's name, statement title, and the period covered. Note how net income (or loss) from the *income statement* flows into the *statement of retained earnings*. Recall that

1. Retained earnings are increased by revenues and, therefore, net income
2. Retained earnings are decreased by expenses and, therefore, a net loss
3. Retained earnings are also decreased by any dividends paid, since these earnings are not retained.

| | | |
|---|---|---|
| | Retained Earnings, Beginning | $0 |
| *plus:* | Net Income | $13,500 |
| | | $13,500 |
| *less:* | Dividends | $5,000 |
| *equals:* | Retained Earnings, Ending | $8,500 |

**Statement of Retained Earnings – In *Good Form***

Below is the basic format for the *statement of retained earnings*. It is in *good form*. Good form includes a heading with the firm's name, statement title, and the period covered.

**Soltis Corporation**
**Statement of Retained Earnings**
**For the Month Ended December 31, 2013**

| | | |
|---|---|---|
| | Retained Earnings, Beginning | $0 |
| *plus:* | Net Income | $13,500 |
| | | $13,500 |
| *less:* | Dividends | $5,000 |
| *equals:* | Retained Earnings, Ending | $8,500 |

The statement of retained earnings summarizes earnings retained. Dividends, of course, are earnings that have not been retained. This component of earnings was paid to shareholders. The statement of retained earnings provides for a mechanical link between the firm's income statement and balance sheet.

**Balance Sheet – Not in *Good Form***

Below is the basic format for the *balance sheet*. It is not in *good form*. Good form would include a heading with the firm's name, statement title, and the balance sheet date for a point in time.

Note that assets are listed in order of liquidity.[11] While only one liability (trade accounts payable) was used in the introductory illustration of transactions, other liabilities will be introduced in later chapters. Liabilities are also listed in order of liquidity, where the liabilities expected to be paid first are listed first, the liability expected to be paid second is listed second, and so on.

| | |
|---|---|
| Cash | $3,500 |
| Accounts Receivable | $0 |
| Supplies | $20,000 |
| Property, plant & equipment | $35,000 |
| Total assets | $58,500 |

| | |
|---|---|
| Accounts payable | $0 |
| Common stock | $50,000 |
| Retained earnings | $8,500 |
| Total equities | $58,500 |

Also note that ending retained earnings, from the *statement of retained earnings*, is represented in the *balance sheet*.

| | | |
|---|---|---|
| | Retained Earnings, Beginning | $0 |
| *plus:* | Net Income | $13,500 |
| | | $13,500 |
| *less:* | Dividends | $5,000 |
| *equals:* | Retained Earnings, Ending | $8,500 |

[11] Cash is the most liquid asset, so it is listed first. Trade accounts receivable are next in the sequence. Supplies inventory are listed after trade accounts receivable. Property, plant & equipment are required for the ongoing operation of the firm, so it is not a liquid asset in the ordinary course of "ongoing" operations (going concern assumption). Generally, ongoing operations (i.e., no liquidation or bankruptcy) are presumed when preparing (historical cost-based) financial statements.

**Balance Sheet – In *Good Form***

Below is the basic format for the *balance sheet*. It is in *good form*. Good form includes a heading with the firm's name, statement title, and the point in time.

**Soltis Corporation**
**Balance Sheet**
**December 31, 2013**

| Assets | |
|---|---|
| Cash | $3,500 |
| Accounts Receivable | $0 |
| Supplies | $20,000 |
| Property, plant & equipment | $35,000 |
| Total assets | $58,500 |

| Liabilities and Owners' Equity | |
|---|---|
| Accounts payable | $0 |
| Common stock | $50,000 |
| Retained earnings | $8,500 |
| Total equities | $58,500 |

The balance sheet provides a summary of balances for all assets, liabilities and owners' equity accounts at the end of the accounting period.

**Statement of Cash Flows – Not in *Good Form***

Below is the basic format for the *statement of cash flows*. It is not in *good form*. Good form would include a heading with the firm's name, statement title, and the period covered. Note the separation of the statement of cash flows into the 3 basic business activities covered earlier in this chapter: (1) operating, (2) investing, and (3) financing activities.

| | | |
|---|---|---|
| Cash flows from operating activities: | | |
| Cash received from clients | $17,500 | |
| Cash paid for supplies | ($20,000) | |
| Cash paid for rent | ($2,500) | |
| Cash paid for salaries | ($1,500) | ($6,500) |
| Cash flows from investing activities: | | |
| Purchase of property, plant & equipment | ($35,000) | ($35,000) |
| Cash flows from financing activities: | | |
| Cash received for common stock | $50,000 | |
| Dividends paid in cash | ($5,000) | $45,000 |
| Net increase in cash | | $3,500 |
| Cash balance, beginning | | $0 |
| Cash balance, ending | | $3,500 |

**Statement of Cash Flows – In *Good Form***

Below is the basic format for the *statement of cash flows*. It is in *good form*. Good form would include a heading with the firm's name, statement title, and the period covered. Note the separation of the statement of cash flows into the 3 basic business activities covered earlier in this chapter:

(1) Operating activities.
(2) Investing activities.
(3) Financing activities.

**Soltis Corporation**
**Statement of Cash Flows**
**For the Month Ended December 31, 2013**

| | | |
|---|---|---|
| Cash flows from operating activities: | | |
| Cash received from clients | $17,500 | |
| Cash paid for supplies | ($20,000) | |
| Cash paid for rent | ($2,500) | |
| Cash paid for salaries | ($1,500) | ($6,500) |
| Cash flows from investing activities: | | |
| Purchase of property, plant & equipment | ($35,000) | ($35,000) |
| Cash flows from financing activities: | | |
| Cash received for common stock | $50,000 | |
| Dividends paid in cash | ($5,000) | $45,000 |
| Net increase in cash | | $3,500 |
| Cash balance, beginning | | $0 |
| Cash balance, ending | | $3,500 |

The statement of cash flows may be the most useful of the four financial statements, but it also the most complex to produce, read and understand. Its production requires a beginning balance sheet, an income statement for the period, and an ending balance sheet. Therefore, it is produced from two balance sheets and an income statement, so it should make sense that the statement of cash flows would provide users with more information.

Soltis Corporation
Income Statement
For the Month Ended December 31, 2013

| | |
|---|---|
| Revenues | $17,500 |
| Expenses | $4,000 |
| Net Income | $13,500 |

Soltis Corporation
Statement of Retained Earnings
For the Month Ended December 31, 2013

| | | |
|---|---|---|
| | Retained Earnings, Beginning | $0 |
| *plus:* | Net Income | $13,500 |
| | | $13,500 |
| *less:* | Dividends | $5,000 |
| *equals:* | Retained Earnings, Ending | $8,500 |

Soltis Corporation
Balance Sheet
December 31, 2013
Assets

| | |
|---|---|
| Cash | $3,500 |
| Accounts Receivable | $0 |
| Supplies | $20,000 |
| Property, plant & equipment | $35,000 |
| Total assets | $58,500 |

Liabilities and Owners' Equity

| | |
|---|---|
| Accounts payable | $0 |
| Common stock | $50,000 |
| Retained earnings | $8,500 |
| Total equities | $58,500 |

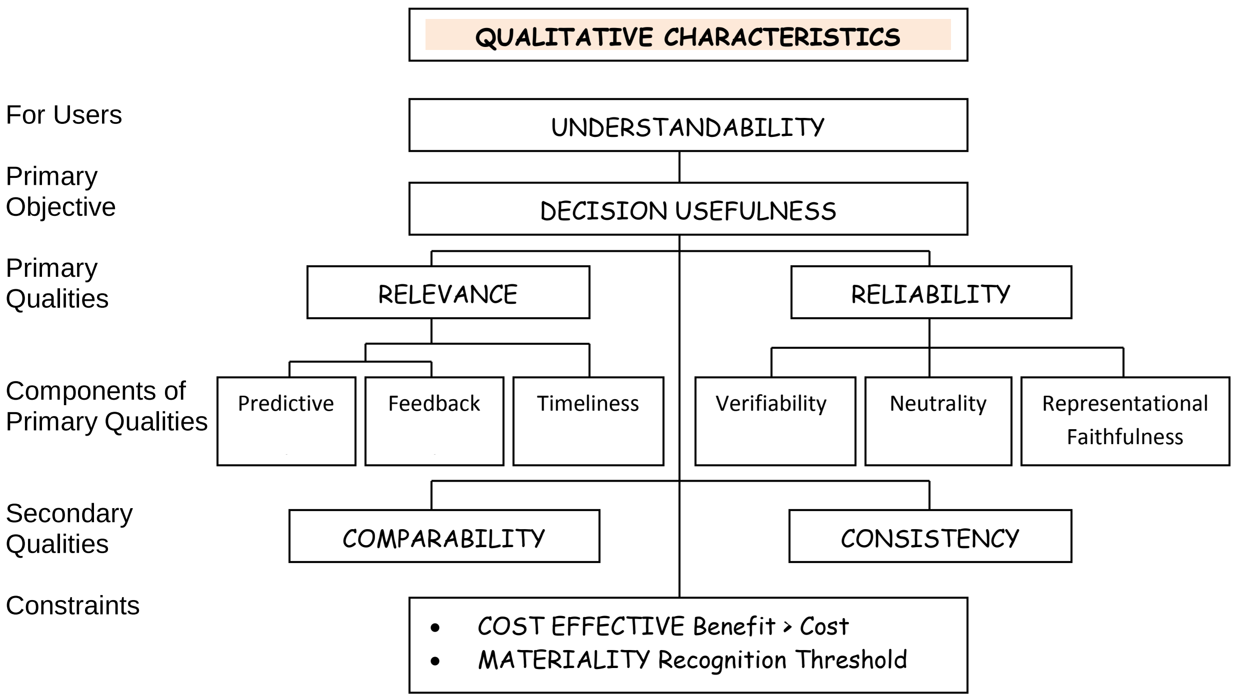
Soltis Corporation
Statement of Cash Flows
For the Month Ended December 31, 2013

| | | |
|---|---|---|
| Cash flows from operating activities: | | |
| Cash received from clients | $17,500 | |
| Cash paid for supplies | ($20,000) | |
| Cash paid for rent | ($2,500) | |
| Cash paid for salaries | ($1,500) | ($6,500) |
| Cash flows from investing activities: | | |
| Purchase of property, plant & equipment | ($35,000) | ($35,000) |
| Cash flows from financing activities: | | |
| Cash received for common stock | $50,000 | |
| Dividends paid in cash | ($5,000) | $45,000 |
| Net increase in cash | | $3,500 |
| Cash balance, beginning | | $0 |
| Cash balance, ending | | $3,500 |

*Appendix A*

# *Qualitative Characteristics of Accounting Information*

***Qualitative Characteristics* of Accounting Information**
The below introduces the basic structural hierarchy of accounting qualities:




**Primary and Secondary Qualities of Accounting Information**
Primary qualities include relevance and reliability; secondary qualities include comparability and consistency.

- *Relevance* suggests that accounting information possesses the potential to make a difference in the decision-making process. To be relevant, financial information must have (1) predictive or (2) feedback value and must be made available to the decision-maker in a (3) timely manner.
- *Reliability* suggests that accounting information is (1) verifiable, is (2) a faithful representation and is (3) reasonably free from error and bias or is neutral. Verifiability is comparable to objectivity, in that it suggests that independent parties using the same measurement methods will achieve similar results or arrive at comparable conclusions.

- *Comparability* suggests similarity with respect to reporting methods and techniques to facilitate user ease in identifying differences.
- *Consistency* suggests similarity with respect to measurement methods and techniques to facilitate user ease in identifying differences.

**Assumptions of Accounting Information**

Basic assumptions underlying the financial accounting structure or framework include the

1. *Business* or *Economic entity* assumption, which presumes that transactions can be identified with a particular firm or entity, separable from other entities (e.g., department, division, subsidiary and firm).
2. *Going concern* assumption, which presumes the firm to have an unlimited or long life. This assumption justifies the use of historical cost. If, alternatively, we assumed that the firm was about to fail or liquidate, the financial statements would be more useful if adjusted to liquidation or net realizable value (NRV) and recording depreciation, depletion or amortization expenses would serve no purpose.
3. *Monetary unit* assumption, which assumes, for example, that U.S. firms and their use of the U.S. dollar is justified as this monetary unit is relevant, easy to use, universally available, understandable, stable and, therefore, useful. Price-level changes from inflation and deflation are ignored under this assumption. In cases of very high or hyper-inflation, for example, this assumption would fail to remain applicable and/or inflation-accounting might replace historical cost.
4. *Periodicity* (*Time*) assumption, which allows for economic positions and results to be divided into artificial time periods (e.g., months, quarters and years).

**Principles of Accounting Information**

Basic principles of accounting used to record transactions include the

1. *Historical cost* principle, under U.S. GAAP, continues to require that most assets and liabilities be accounted for and reported at cost. This is an objective and reliable measure, and, at the date of acquisition, historical cost and fair market value (FMV)[12] are presumed to represent equivalent measures.
2. *Revenue recognition* principle provides guidance on when revenues are to be recorded. Revenue is recognized when (1) earned – when services are provided or the ownership of goods is transferred, (2) is not dependent on cash receipt – a sale may be made on credit terms, and (3) is measured at the FMV of cash and other consideration received.
3. *Matching* principle requires that the expense follow or be matched with the revenue. In some cases, a “rational and systematic” method of allocation is used when the matching principle is not otherwise clear or apparent. It is helpful to classify costs as product (e.g., direct material, direct labor and manufacturing overhead) and period (non-product) costs, when applying the matching principle.
4. *Full disclosure* principle requires that note or footnotes and supplemental information be provided in addition to the basic financial statements.

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[12] Defined as the value at which an exchange takes place, when neither the buyer nor seller is under any pressure or compulsion to buy or sell.

**Constraints to Accounting Information**
Constraints to accounting information and usefulness include the
1. *Cost-benefit relationship*, as the production of information is not free.
2. *Materiality*, as immaterial (or insignificant) items, a matter of professional judgment, may not provide added value or decision-usefulness to users and may even distract users of financial information from relevant matters.
3. *Industry practice* may take priority in some industries (e.g., commodities).
4. *Conservatism* requires that, when in doubt, select the solution that is least likely to overstate assets and income.

**Types of Business Organization**
There are 3 basic forms of business organization:
- Sole Proprietorship or Proprietorship:[13] This business form has only 1 owner and is a separate accounting entity, but not a separate legal entity, leading to unlimited liability.
- Partnership (General or Limited) or Limited Liability Partnership (LLP) or Limited Liability Company (LLC):[14] This business form has 2 or more partners and is formed through an oral or written agreement, which outlines how income and losses are to be shared or distributed to the partners. General partners have unlimited or joint and several liability with respect to the liabilities incurred by the partnership, but there are 3 forms of partnerships that may limit the liability exposure by certain classes of partners.
    - Limited Partnership (LP): An LP has both general and limited partners, where limited partners are called "limited" partners, because their liability is limited.[15] General partners participate in the day-to-day management of the partnership and are jointly and severally liable.
    - LLP: An LLP limits a partner's liability to events evolving from their own actions (or the actions of those under their control), protecting an uninvolved partner from the negligent actions of another partner. However, all partners remain responsible for partnership debts.
    - LLC: An LLC provides for the limited liability of a corporation, which is a separate legal entity, but it taxed like a partnership.
- Corporation (C or S):[16] This business form represents a separate legal entity with an unlimited life. Generally, shareholders or stockholders are not personally liable for

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[13] These entities use and attach a Schedule C or F (for farms and ranches) to their Form 1040 to report taxable profits to the IRS.
[14] These entities use a Form 1065 to report the character of income and expense items to the IRS. Partners receive a Form K-1, based on their distributive share of the 1065 line items, and use this information to prepare their individual Form 1040.
[15] While state laws dictate, generally, limited partner losses are limited to their investment plus any assessments that may be provided for in the partnership agreement.
[16] C Corporations are tax-paying entities and file a Form 1120 with the IRS. S Corporations are non-tax-paying entities and file a Form 1120S with the IRS. Each

corporate actions or debts. Ownership is divided into shares of stock. Under the Internal Revenue Code (IRC), there are 2 corporate forms or IRC subsections.

- C Corporation: Most of the firms listed on US stock exchanges are C corporations and taxed at the corporate level and a second time, for dividends, when paid and at the individual stockholder level. This double-taxation of dividends is one of the disadvantages of this corporate form.
- S Corporation: This form of organization is not subject to double-taxation, as is the case with the C corporation. Shareholders of S corporations are taxed like partners in a partnership.

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shareholder receives a Form K-1 from the S Corporation to prepare their individual Form 1040.

*Appendix B*

# *Return on Assets*

# *[Risk & Return]*

Revenues are often referred to as the "top line" and net income (NI) is often referred to as the "bottom line." Therefore, when firms produce their quarterly or annual financial statements, reference will be made to "top line growth" and "bottom line growth."

| | |
|---|---|
| **Revenues (top line)** | **$3,500** |
| **Expenses** | **$2,500** |
| **Net Income (bottom line)** | **$1,000** |

Net income or the bottom line makes it possible to compute the "return" or "rate of return." A common or popular measure of the rate of return is return on assets (ROA). It represents net income divided by assets employed to generate this return:

**Return on Assets = Net Income ÷ Assets**

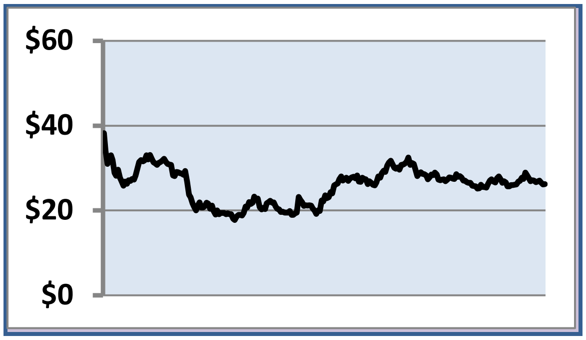
For example, if we assume that assets in the amount of $10,000 were required to generate the net income of $1,000 in the above example, our return on assets would be 10%:

**10% = $1,000 ÷ $10,000**

Rates of return vary for alternative investments. Investing in a savings account or U.S. Treasury securities might generate a rate of return or return on assets at 1% or 2%, with little or no risk. Alternatively, we might decide to invest in a firm's stock, where a rate of return or return on assets invested might be higher, but is less assured and represents a higher risk. There is a risk versus return trade-off.

Varying levels of risk can be associated with varying levels of both return and uncertainty. Higher risk suggests higher levels of uncertainty. Lower risk suggests lower levels of uncertainty. You might, for example, prefer to invest your cash or assets in Facebook stock instead of a savings account, hoping for a higher return, but there is less certainty with this investment in Facebook stock, which is riskier.

For example, below is a graph of the closing price per share of Facebook stock for the first twelve months after the firm's IPO on May 18, 2012:




The high stock price of $45 per share occurred on this IPO date. Despite this high IPO date price per share, the stock closed at only $38.23 per share. The stock closed at $26.25 per share, one year later, on May 17, 2013.

Therefore, if you purchased one share of Facebook stock at the closing price of $38.23 per share on May 18, 2012, one year later, on May 17, 2013, you generated a negative return or net loss on assets, in this case, the cash you invested:

| | |
|---|---|
| May 17, 2013 Closing Price per Share | $26.25 |
| May 18, 2012 Closing Price per Share | $38.23 |
| Negative Return or Net Loss | $11.98 |

Investing in Facebook was a risky investment. Your rate of return, after the first year, is negative:

$26.25 ÷ $38.23 = 69% - 100% = -31%

or

$26.25 ÷ $38.23 = $(11.98) ÷ $38.23 = -31%

If Facebook stock returns to its high price of $45, the rate of return would be favorable, as follows:

$45.00 ÷ $38.23 = 118% - 100% = 18%

or

$45.00 ÷ $38.23 = $6.77 ÷ $38.23 = 18%

*Appendix C*

# *Framework for Business Activities*

There are three major classifications of business activities: operating, investing and financing. Operating, investing and financing activities represent all components of a firm's balance sheet, as follows:

| Assets | = | Liabilities | + | Owners' Equity | Activity |
|---|---|---|---|---|---|
| Current | | Current | | Net Income/(Loss) | OPERATING |
| Non-Current | | | | | INVESTING |
| | | Non-Current | | Equity | FINANCING |

**1-Operating Activities**
Operating activities or operations are financed with current assets and current liabilities or working capital. Generally, current assets include cash and those assets expected to result in cash inflows during the next operating period or cycle and current liabilities include those liabilities expected to result in cash outflows during the next operating period or cycle. Current assets less current liabilities represent the capital that the firm will "put to work" or use to operate over the next operating period or cycle. It is called "working capital," as follows:

**Current Assets – Current Liabilities = Working Capital used for Operations**

If working capital is a negative amount, there is a serious risk that the firm will not be able to continue to operate during the current operating period or cycle. Therefore, negative working capital suggests that firm might actually cease to represent a "going concern."

**2-Investing Activities**
Investing activities or investments are made and take the form of long-term or non-currents assets, including property, plant and equipment and investments in stocks and bonds of other firms. Over time, these investments in non-current assets might be purchased or sold.

**Non-Current Assets = Investment**

**3-Financing Activities**

Financing activities or financing is achieved through the sale of bonds or other long-term borrowings and/or the sale of stock or equities. Bond holders receive interest, and expense to the firm and resulting in the reduction of the firm's net income. Stock holders receive dividends. Dividends are paid from net income and reduce the earnings retained by the firm. Over time, stocks and bonds might be issued by the firm to fund long-term activities.

**Non-Current Liabilities + Equities = Financing**