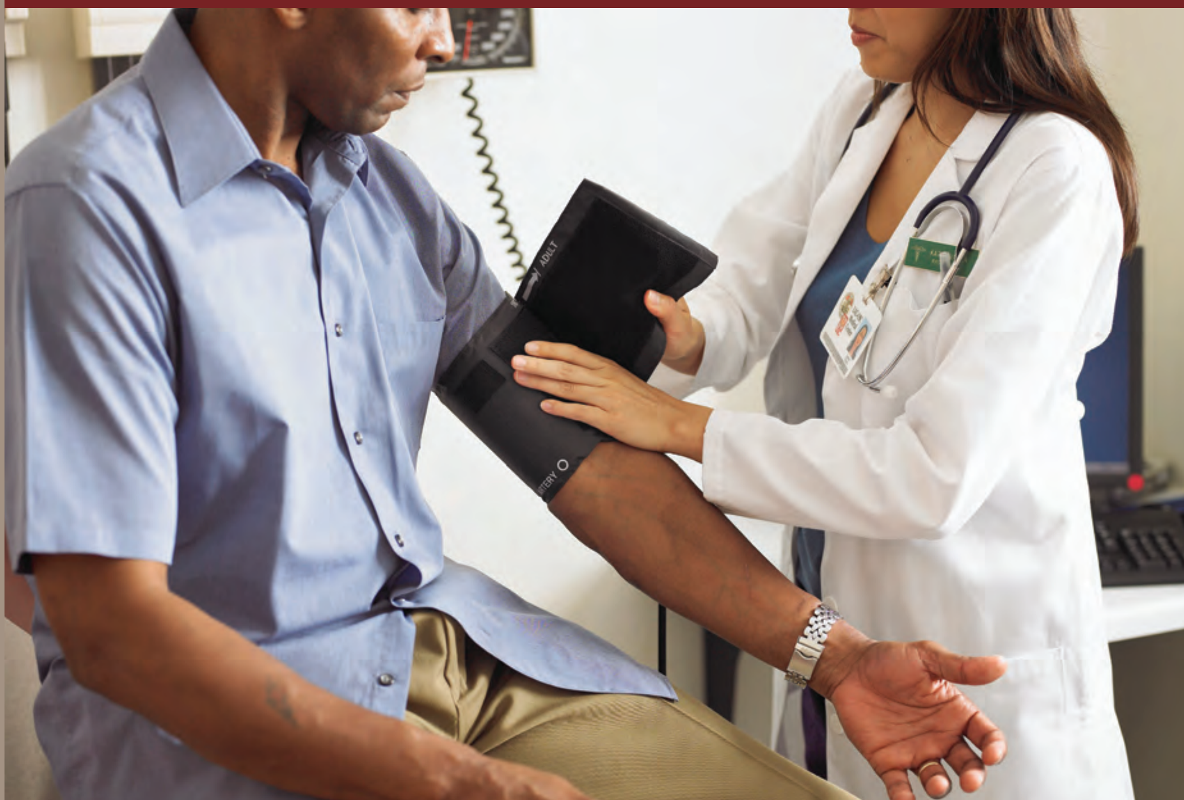
Chapter 2

Introduction to Accounting



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Learning Objectives

- Differentiate between financial and managerial accounting.
- Acquire knowledge about basic accounting concepts.
- Learn the fundamental accounting equation and the impact of transactions.
- Discover career paths within the accounting profession.

Chapter Outline

Introduction

The stereotypical accountant is characterized as a boring number cruncher, charged with maintaining the books and accounts of a business. This image may be traced back to the 1843 book by Charles Dickens entitled *A Christmas Carol*. In that tale, Ebenezer Scrooge is a penny-pinching miser who cares nothing for the people around him. His sole purpose is making money, and his trusted but suffering accountant is Bob Cratchit, who painstakingly tracks every penny. Mr. Scrooge eventually sees the light, but that's another story.

Today's accountant is also another story. The mundane aspects of accounting are now largely accomplished by sophisticated computer software. For small businesses, the software may reside on a simple personal computer. Larger businesses may use elaborate enterprise resource packages that integrate accounting with all other aspects of managing the business. Such complex business systems may be maintained internally by a specific business or may be contracted for through a third-party "cloud computing" service provider. However your healthcare organization manages its accounting function, you will need to understand the numbers generated by this function, as well as the numbers you will be sending to accounting to add to its books. You will work with accounting to pay bills, and you will need to use the numbers reported monthly to be sure your department in staying on budget. If it is not, you will need to be able to analyze these numbers and find the problem.

The changed environment has redefined what it means to be an accountant, as well as what it means to be a manager or other decision maker. Although accountants certainly need to have comprehensive understanding of the fundamental practices, rules, and procedures constituting the foundation of accounting, they are oftentimes more focused on broader measurement, reporting, and managerial tasks. Less time is spent on data capture, and more time is devoted to analyzing information and helping with sound business decisions.

Furthermore, to understand and monitor results produced by sophisticated information systems, accountants need to be knowledgeable and vigilant. If their organizations solely rely on the data produced by their computers, decision making can be quickly handicapped by erroneous output. The accountant must have a keen "forensic" eye to make sure that reported information is logical and correct. As a healthcare manger or decision maker, you will also need to review the output from accounting for the sections you lead, so you can identify cases in which reported information is not logical or is incorrect. Indeed, the role of accounting has grown more complex, and with that complexity, the value of the accountant has increased. A large proportion of business leaders start out as accountants.

2.1 The Language of Accounting

As noted, accounting is the collective concepts and techniques used to measure and report financial information about an entity. Managers and business executives are generally expected to possess at least rudimentary knowledge of this language. It is not essential that they know every nuance or specific rule, but they must be at least functionally literate in basic concepts. Indeed, it is very difficult to intelligently read and understand essential accounting reports without a firm grasp of accounting principles. No matter what career you pursue, you will come to appreciate the material you will learn in this course.

Disciplines of Accounting

At its core, accounting is a tool for providing information for decision making. Decision makers include owners, managers, creditors, employees, government, and other interested parties. In one way or another, these users of accounting information tend to be concerned about their own interests in the entity, and each may have different ideas about the information they seek. This leads to a natural division of specialties within the accounting field.

Some accountants focus on taxation. Tax returns must be prepared according to established laws, rules, and regulations. Tax accountants are also heavily involved in planning and strategy. The tax ramifications of significant transactions must be carefully evaluated. Businesses must consider complex implications of doing business in multiple states and countries.

Other accountants focus on **managerial accounting**. Managerial accounting information is intended to serve the specific needs of management. Business managers are charged with business planning, controlling, and decision making. As such, they may desire specialized reports, budgets, product-costing data, and other details that are generally not reported on an external basis. Further, management may dictate the parameters under which such information is to be developed.

Another major area of accounting emphasis is **financial accounting** and auditing. Financial accounting is targeted toward reporting financial information about a business to external users such as the owner(s) and creditors. These parties often lack direct access to underlying details about day-to-day operations of the business and depend on summarized (frequently audited) financial statements to form their opinions about whether to invest in or lend to the business. As a result, their ability to understand and have confidence in reports directly depends on the standardization of principles and practices used to prepare the reports. Without such standardization, reports of different companies could be hard to understand and even harder to compare. Auditors provide independent oversight and assurance about the fairness and accuracy of reported financial accounting information. This introductory course is largely about financial accounting. It is the right place to begin your studies of accounting because understanding core financial accounting principles is essential for business success. Furthermore, many tax and managerial accounting processes are derivatives of the financial accounting model.

Financial Accounting

Financial accounting focuses on correctly measuring and reporting information about a business's transactions and events. This information must be captured and summarized into reports that are used by persons interested in the entity. This task is far more complex than most people appreciate. It involves a talented blending of technical knowledge and applied judgment. Understanding financial accounting begins with an understanding of the overall structure of accounting and the fundamental reporting model that is common to all business entities.

As noted, standardization of reporting is a hallmark of financial accounting. Such standardization derives from certain well-organized processes and organizations. As Chapter 1 explained, in the United States, a private-sector group called the **Financial Accounting Standards Board (FASB)** is primarily responsible for developing the rules that form the foundation of financial reporting. For governmental entities, the rules are developed by the **Governmental Accounting Standards Board (GASB)**. The FASB's global counterpart is the **International Accounting Standards Board (IASB)**. The IASB (http://www.iasb.org/Home.htm) and FASB (http://www.fasb.org/home) work cooperatively on many projects, and a single harmonious set of **international financial reporting standards (IFRS)** might eventually emerge. This effort to establish consistency in global financial reporting is motivated by the increase in global business.

Financial reports prepared under the GAAP promulgated by such standard-setting bodies are intended to be general purpose in orientation. This means that they are not prepared especially for owners, creditors, or any other particular user group. Instead, they are intended to be equally useful for all user groups.

2.2 Key Concepts

The development of GAAP has occurred over many decades, and serious attempts have been made to base individual rules on thoughtful conceptual guideposts. Foremost is the idea of decision usefulness. Financial accounting information is intended to facilitate decisions about investing and lending. At a macro level, accounting information is the basis upon which capital is allocated in a free market economy. Investors like to invest where profits are best, and creditors like to loan when they foresee that they are apt to be repaid. The best businesses and business opportunities attract capital via signals about their performance, and those signals emanate from the financial reporting model. Without this flow of information and capital, a modern economy would stutter.

To be useful for decision making, accounting information should be relevant and reliable. **Relevance** means the degree that accounting information bears on the decision process, primarily by providing timely feedback on an enterprise's financial condition and performance. Information is also seen as relevant if it possesses predictive value. **Reliability** relates mostly to truthfulness but also contemplates freedom from bias (neutral).

Accounting information should also possess the qualities of **comparability** and **consistency**. Comparability generally relates to the ability to make relative assessments of companies. Investors and creditors all have limited resources and will clearly seek to place their funds with companies offering the best returns commensurate with understandable risk levels. This necessarily entails the need to compare companies. Accounting should facilitate such comparisons. This does not mean that all companies must use identical accounting techniques. Accounting disclosures, however, should possess sufficient detail so that careful users can discern differences in firms that are based on economic differences rather than accounting choice. Consistency is a concept that relates to performance assessments over time. Basically, if a firm's economic activity is consistent from period to period, its accounting measures should also be consistent. Differences in measured outcomes from period to period should be indicative of deviations in business results.

Despite accounting's appearance as concrete and absolute, this is not quite true. Accounting information is often based on arbitrary allocations, assumptions, and individual judgment. Although rooted in mathematics, it nevertheless remains a social science. This concept is often misunderstood, resulting in perhaps excessive fixation on reported results for a single period of time. For example, how much profit is earned in a particular month or quarter when a cell phone is sold for less than cost, but the purchaser is also required to subscribe to a profitable 2-year service plan? There are no absolute answers to such questions; instead, accountants routinely embrace estimates and assumptions in the development of periodic financial reports.

It is also important to note that it has not been accounting's historic role to value a business. Accounting information may be useful in supporting this objective, but it is not a primary objective. As such, many transactions and events are reported based on their **historical cost**. For example, land is typically recorded and carried in the accounting records at its purchase price. The historical cost principle is based on the concept that it is best to report certain financial statement elements at amounts that are tied to objective and verifiable past transactions.

An often-debated alternative to historical cost is the **fair value** (in contrast to historical cost), or fair market value (FMV), approach. Under this technique, assets and liabilities are periodically revalued based on assessments of current worth, or FMV. Although problematic to implement, proponents of this view argue that it provides more relevant information for decision making. The competing viewpoint holds that FMV accounting is entirely too subjective to form a reliable basis for reporting. Currently, selected financial instruments may be valued at fair value. Otherwise, most U.S. companies adhere fairly well to historical cost measurement principles. Some global firms deploy more extensive fair value reporting, and it is possible that fair value accounting will gain more traction in years to come. The accountant of the future may be called on to develop added skills in valuation methods. This observation is consistent with the ever-changing role of the accounting profession.

There are many other guiding principles that you will be exposed to throughout this course. Table 2.1 provides a very high-level view of additional selected concepts and principles that drive accounting practice and judgment.

Table 2.1: Selected concepts and principles

Basic Concepts, Principles, and Assumptions	
Materiality	Accountants are only concerned with decisions about how to account for matters that would bear on a decision-making process about the entity.
Monetary unit	Accountants describe the amounts reported on financial statements in measures of money rather than some other basis (e.g., land in acres).
Going concern	In the absence of evidence to the contrary, accountants assume that the business will continue to operate into the future.
Periodicity	Accountants assume that business activity can be divided into measurement intervals, such as months, quarters, and years.
Economic entity	Accountants present information along the lines of distinct economic units.
Full disclosure	Accountants hold to the principles that all relevant information is adequately described and presented within financial statements and related notes.
Stable currency	Accountants presume that the currency used to measure financial statement elements is not significantly changed over time because of inflationary effects.

2.3 The Financial Reporting Model

Despite major advances in accounting technology and significant growth in the controlling rule set (there are well in excess of 20,000 specific accounting rules), the intrinsic model has changed little over the course of more than 500 years. The model traces its roots to the Renaissance era. A monk named Luca Pacioli developed a method for tracking the success or failure of ocean-going trading ventures. Capitalists of that era pooled their money to invest in ships that circled significant parts of the globe to trade goods. These returning ships then sold the collected wares. What was lacking was a way to track the costs and benefits of these efforts. Friar Pacioli met the challenge by developing a mathematical model that is still central to even the most sophisticated accounting systems of the modern age.

Central to the model is the concept that a business entity can be described as a collection of assets and corresponding claims against those assets. Some claims belong to creditors of the business, and the residual claims belong to the owner(s). This gives rise to the following accounting equation:

Assets = Liabilities + Owner's Equity

Depending on your life's experiences, this may or may not seem intuitive. If you own your home or car (an asset) but bought it with a loan on which you still owe some amount, you can probably relate. For example, assume that you bought a house for $200,000 but still owe $125,000 on the loan. Your fundamental accounting equation would be as follows:

$200,000 (your asset) = $125,000 (your liability) + $75,000 (your equity)

You would report that you have equity in your home of $75,000. This is the amount you would get to keep if you sold the home for $200,000.

In general, **assets** are the economic resources of the entity and include such items as cash, accounts receivable (amounts owed to a firm by its customers), inventories, land, buildings, equipment, and even intangible assets such as patents and other legal rights and claims. Assets are presumed to entail probable future economic benefits to the owner. As previously noted, many assets are measured and reported at their historical cost in the accounting records.

Liabilities are the amounts owed to others. Such obligations arise from loans, extensions of credit, and other obligations that occur in the normal course of business.

Owner's equity is the owner's "interest" in the business. Because it is equivalent to assets minus liabilities, it also referred to as the **net assets** of a particular business. For a sole proprietorship, the equity would typically consist of a single owner's capital account. With a partnership, a separate capital account is maintained for each investor. A corporation's ownership is represented by divisible units called shares of capital stock. These shares are easily transferable, with the current holder(s) of the stock being the owner(s). The total owner's equity (i.e., stockholders' equity) of a corporation usually consists of several amounts. This generally corresponds to the owner investments in the capital stock (by shareholders) and additional amounts generated through earnings that have not been paid out to shareholders as **dividends**. (Dividends are distributions to shareholders as a return on their investment.) These undistributed earnings are customarily termed the **retained earnings** of the business.

Knowledge of the fundamental accounting equation is key to understanding one of the most basic financial statements: the **balance sheet**. A balance sheet reveals the assets, liabilities, and equity of a business at a particular time. Examine Exhibit 2.1, the balance sheet for Kaplan's Medical Clinic. Note that the balance sheet's date is as of a particular time, as indicated by the specific date attached to the statement.

Exhibit 2.1: Balance sheet for Kaplan's Medical Clinic

Kaplan's Medical Clinic Balance Sheet December 31, 20X3				
Assets		**Liabilities**		
Cash	$ 54,000	Accounts payable	$ 4,500	
Accounts receivable	135,000	Loan payable	57,000	
Supplies	4,500	Total liabilities		$ 61,500
Land	95,000	**Stockholders' equity**		
		Capital stock	$ 52,000	
	–	Retained earnings	175,000	227,000
Total assets	$ 288,500	Total liabilities and equity		$ 288,500

Notice that the balance sheet reveals a listing of assets totaling $288,500. The business owes various creditors a total of $61,500, leaving $227,000 of residual equity attributable to the shareholders of the business. The fundamental accounting equation for Kaplan's Medical Clinic is

> $288,500 (total assets) = $61,500 (total liabilities) + $227,000 (total stockholders' equity)

The equity of $227,000 does not mean that the business is worth $227,000. Remember that many assets are not reported at current value. For example, although the land is reported at its cost of $95,000, it could be worth more. Similarly, the business likely has unrecorded resources such as its brand name and patient base. In a contrary fashion, the business may face business risks or pending litigation that might restrict its value. Thus, accounting statements are important in investment and credit decisions, but they are not the sole source of information for evaluating a business.

Sources of Capital

Kaplan's Medical Clinic reported total equity of $227,000. What was the source of that capital? One would generally conclude that it was invested by the company's shareholders. However, there is another important source of capital to consider, and that is the earnings of the business. Hopefully, over time, a business will prove to be profitable for its owners. The shareholders might receive periodic dividends; however, much of the income will likely be left in the business and be reinvested in additional business assets. Thus, equity arises from two principal sources: capital investments and retained earnings.

Before proceeding further, it is important to consider concepts of business income. **Income** can be thought of as the enhancement to the business as a result of providing goods (for example, medical equipment, medications, inoculations, or other medically necessary procedures that require goods to be sold) and health services to its patients. Mathematically, it is the result of subtracting expenses from revenues. **Revenues** are the gross inflows from patients, and **expenses** are the costs incurred in the process of producing those revenues. It is important to note that income and revenue are not synonymous. Very simply, income is revenues minus expenses. Some refer to revenue as the top line and income as the bottom line. You have already seen a balance sheet for Kaplan's Medical Clinic. Exhibit 2.2 is an **income statement**. Note, in particular, the date range shown on the income statement. It is important to identify carefully the period of time during which the revenues and expenses were generated. These revenues are adjusted by contractual allowances (i.e., discounts negotiated by insurance companies and governmental entities), charity care, and other administrative adjustments. Most companies will show the revenues as Net Revenues minus these adjustments. Some companies will show the Gross Revenues and include one or more line items for adjustments to revenue.

Exhibit 2.2: Income statement for Kaplan's Medical Clinic

Kaplan's Medical Clinic Income Statement For the Month Ending December 31, 20X3		
Revenues		
Services to customers		$ 90,000
Expenses		
Wages	$ 37,000	
Supplies	13,000	
Total expenses		50,000
Net income		$ 40,000

Perhaps it goes without saying that a business can also lose money. In other words, expenses can exceed revenues. When this happens, the business is said to have a net loss, and this will reduce retained earnings. Severe losses can erode owner investments and result in negative retained earnings, or accumulated deficit.

When a business pays dividends to stockholders, such amounts are not reported as expenses. Granted, they are an outflow from the business, but they are reported separate from the income statement. Dividends are a distribution of income, not a reduction in income. Often, a **statement of retained earnings** is prepared. This statement builds a bridge between the retained earnings that existed at the beginning and end of a particular period. Exhibit 2.3 is an example of the statement of retained earnings for Kaplan's Medical Clinic.

Exhibit 2.3: Statement of retained earnings for Kaplan's Medical Clinic

Kaplan's Medical Clinic Statement of Retained Earnings For the Month Ending December 31, 20X3	
Beginning balance—December 1, 20X3	$ 130,000
Plus: Net income	40,000
	$ 170,000
Less: Dividends	5,000
Ending balance—December 31, 20X3	$ 175,000

If you take time to review the financial statements for a public company that you are familiar with (they are often found on a company's website under "Investor Relations"), you might find an expanded **statement of stockholders' equity** in lieu of the statement of retained earnings. The expanded statement not only explains the periodic change in retained earnings but also shows all other sources of changes in equity. Examples include issuing additional shares of stock, dividends paid in shares of stock, and other unique events. These topics will be covered in a later chapter. For now, let's stick with the basic statement of retained earnings.

It is important to note that the income statement, statement of retained earnings, and balance sheet mesh together in a self-balancing fashion. Exhibit 2.4 shows how income flows from the income statement into the statement of retained earnings. Additionally, note how the ending retained earnings from the statement of retained earnings also appear in the balance sheet. This final tie-in causes the balance sheet to balance.

Exhibit 2.4: Flow of income

Kaplan's Medical Clinic Balance Sheet December 31, 20X3		
Assets		
Cash		$ 65,000
Accounts receivable		75,000
Inventories		35,000
Land		300,000
Building		100,000
Equipment		50,000
Other assets		10,000
Total assets		$ 635,000
Liabilities		
Salaries payable	$ 34,000	
Accounts payable	66,000	
Total liabilities		$ 100,000
Stockholders' equity		
Capital stock	$ 360,000	
Retained earnings	175,000	
Total stockholders' equity		535,000
Total liabilities and equity		$ 635,000

How the articulation of the income statement, statement of retained earnings, and balance sheet occurs may at first seem mysterious, but the following discussion regarding Kaplan's Medical Clinic will begin to clarify the logic of the self-balancing nature of the core financial statements.

You can also find financial statements online for nonprofit healthcare facilities. For example, review the 2012 annual report with its financial statements for the Mayo Clinic at http://www.mayoclinic.org/about/. You will see a link for the annual report at the left. The financial statements are included in that annual report. You will find the Consolidated Statement of Activities (also known as the Income Statement) on page 10 and the Consolidated Statements of Financial Position (also known as the Balance Sheet) on page 11. Note the various types of revenue the clinic receives in addition to medical service revenue: grants and contracts, investment return, contributions, and premium revenue. If you want, you can find out more about each of these types of revenue by reading the annual report. Another section common to nonprofits is noncurrent income in the form of "Contributions not available for current activities." Many times this money is set aside for a construction of a specific facility (often for the purpose specified by the donor) or a specific type of long-term research. There is also a line item for "Unallocated investment return" in the noncurrent income section. This would be money maintained in various investment accounts for future use. On the balance sheet, notice there is just one item for net assets and none for equity. These would be the assets on hand to use in future years, such as multiyear gifts and trusts built from years of donations. In Chapter 1, we discussed the types of equity held by a nonprofit. The Mayo Clinic does not detail its equity holdings on its Balance Sheet, but you can find out more about donors and donations in the other parts of the annual report. Remember, a nonprofit does not have any owners. Many major nonprofit healthcare facilities do post their annual reports online to make it easier for their donors to access the information.

Compare the nonprofit financial statements of the Mayo Clinic to those of a for-profit hospital organization that must report to the SEC. Download the 2012 annual report of Health Management Associates (HMA) at http://ir.hma.com/phoenix.zhtml?c=87651&p=irol-reportsannual. The Consolidated Statements of Income can be found on page 74 of the downloaded PDF, and the Consolidated Balance Sheets are on page 75. The term *consolidated* is used because these are the combined results of all the hospitals owned by HMA. Note how different the revenue section is from that of a nonprofit. There is just one net revenue line item and then a provision for "doubtful accounts." These are essentially accounts for which HMA does not expect to collect payment. These could include charity cases or other types of nonpayers. Also note at the bottom of the statement that there is an earnings per share calculation for common stockholders. You will not see this on a nonprofit statement because there are no stockholders.

On the Balance Sheet you will see a line item called "Goodwill" that is unique to for-profit organizations. Essentially, this includes money that was paid to buy hospitals over and above the worth of the net assets owned by those hospitals. Often when one company buys another, extra money is paid for nontangible assets, such as customer base, reputation, or location. The Goodwill line item is a cumulative account of all money paid above the net assets purchased over the years. Another major difference is the Stockholders' equity section that details the ownership of stockholders. More details about ownership can be found on page 76 in the Consolidated Statements of Stockholders' Equity.

A statement not normally prepared by nonprofits called the Consolidated Statement of Cash Flows can be found for HMA on page 77 of the PDF download. This statement shows the cash flows from operating activities (day-to-day activities of the company), investing activities (purchases of other hospitals, proceeds of sales of assets, and purchases of other assets, such as stocks and bonds), and financing activities (proceeds from new types of debt or the sale of newly issued stock). The bottom line of this statement is the change in the net cash on hand. You can see that on the line item near the bottom called "Cash and cash equivalents at the end of the year." HMA's cash has been going down. The company started 2010 with $106,018,000 and ended 2012 with just over half that—$59,173,000. An investor would take a closer look at where the cash went using this statement. We won't delve into those details here. That's beyond the scope of this class.

Comprehensive Illustration

A primary objective of this chapter is to examine business transactions using the accounting equation. You now have a basis for meeting this objective. Recognize that every business transaction has the potential to impact the assets, liabilities, and equity of a business. That impact will not undermine the self-balancing nature of the accounting equation. The reason should become apparent as you review the following example for Kaplan's Medical Clinic.

The following example includes a summary of transactions and events for Kaplan's for the month of December, followed by a spreadsheet showing how each transaction impacts the overall accounting equation. The beginning-of-month amounts are all assumed, and the ending balances were used to prepare the financial statements illustrated earlier. Table 2.2 lists December's transactions.

Table 2.2: December's transactions for Kaplan's Medical Clinic

Description	Amount	Discussion of How Balance Is Maintained
Provided medical services for cash	$10,000	Cash (an asset) and Revenues both increase; revenues increase income, which increases equity.
Provided medical services to be billed to insurance companies	$30,000	The asset, Accounts Receivable (representing amounts due from insurance companies), is increased, which is matched with an increase in Revenues, Income, and Equity.
Collected amounts due from insurance companies for services previously rendered	$20,000	Cash is increased and Accounts Receivable is decreased, resulting in no change in total assets.
Bought additional supplies on account	$ 2,500	Supplies increase, which increases the expenses of the organization, as does the Accounts Payable liability account, which increases the liabilities of the organization. Expenses are shown on the Income Statement, and Liabilities are shown on the Balance Sheet.
Issued additional shares of stock	$12,000	Cash and the Capital Stock account are both increased by the same amount.
Paid amounts due on outstanding Accounts Payable	$ 6,000	Cash and Accounts Payable are both decreased. These accounts are only shown on the Balance. The purchase of supplies (an expense) is tracked when the initial purchase is made.
Purchased land for cash ($20,000) and incurred a $55,000 loan	$75,000	Land (an asset) goes up by $75,000. This is offset by a $20,000 reduction in Cash. The balancing amount of $55,000 is reflected as an increase in the liability account Loan Payable.
Paid wages to employees	$ 7,000	Cash is decreased, as is Income/Equity via the recording of Wages Expense. This is only an expense and is shown only on the Income Statement.
Paid dividends to shareholders	$ 5,000	Cash is decreased and the Dividends account is increased by the same amount (which causes a decrease in Retained Earnings and Equity).

You should carefully review each transaction's impact within the spreadsheet shown in Exhibit 2.5. This will not be immediately intuitive; you will need to think carefully and slowly about each entry, noting in particular how (1) the transaction impacts the various accounts and (2) the equality of the fundamental accounting equation is preserved. We will take a closer look at the issues specific to collecting for services in a medical environment in Chapter 4.

Exhibit 2.5: Spreadsheet for Kaplan's Medical Clinic for December

	Assets				Liabilities		Stockholders' Equity			
Description	**Cash**	**Accounts receivable**	**Supplies**	**Land**	**Accounts payable**	**Loan payable**	**Capital stock** (increase equity)	**Dividends** (decrease equity)	**Revenues** (increase income, thus equity)	**Expenses** (decrease income, thus equity)
								Retained Earnings		
Beginning balances	$ 50,000	$ 125,000	$ 5,000	$ 20,000	$ 8,000	$ 2,000	$ 50,000		$ 140,000	
Services for cash	+ 10,000								+ 10,000	
Services on account		+ 30,000							+ 30,000	
Collect account	+ 20,000	– (20,000)								
Record use of supplies			– (3,000)							+ 3,000
Buy supplies on account			+ 2,500		+ 2,500					
Pay on account	– (6,000)				– (6,000)					
Additional investment	+ 12,000						+ 12,000			
Buy land with cash and loan	– (20,000)			+ 75,000		+ 55,000				
Pay wages	– (7,000)									+ 7,000
Dividends	– (5,000)	–	–	–	–	–	–	+ 5,000	–	–
Ending balance	$ 54,000	$ 135,000	$ 4,500	$ 95,000	$ 4,500	$ 57,000	$ 62,000	$ 5,000	$ 40,000	$ 10,000

$30,000
Net Income

$30,000 – $5,000 = $25,000
Increase in retained earnings

Plus beginning retained earnings
$140,000

Ending retained earnings
$165,000

$288,500
Total Assets

$61,500
Total Liabilities

$227,000
Total Equity

One challenge of accounting is to evaluate each transaction correctly and make sure that it is properly recorded into the accounts. If recording is not done correctly, the fundamental accounting equation will be violated, and it will not be possible to prepare logically "balanced" financial statements. The ability to evaluate and record transactions becomes routine—with practice—much like learning to play a musical instrument. Don't fret that it is at first a bit confusing. In addition, an actual business would not want to rely on the spreadsheet in Exhibit 2.5 as the heart of its accounting system. Such a system suffers from a number of limitations, which are described in Chapter 3. That chapter will introduce a much better way to record transactions and process them into correct financial statements.

2.4 Usefulness of Accounting in Careers and Life

You have probably heard that accounting is a great subject to study, maybe because it is one of the better academic pathways to a good job. If you enjoy accounting and want to stay in the health field, every healthcare institution needs accountants. Even if you aren't interested in accounting as a profession, you will need to understand the role of accounting as a manager in a healthcare organization in order to manage the finances of your department or division. In addition, the skills you will learn will prove helpful in managing your personal finances and investments. These are lifelong skills that will continue to serve you for many years to come.

If you decide to become an accountant, you will find that there are many specialty areas. Many accountants specialize in public accounting, which involves providing audit, tax, and consulting services to the general public. Specializing in public accounting usually requires licensing. Individual states issue a license called a **certified public accountant (CPA)**. **Auditing** involves the examination of transactions and systems that underlie an organization's financial reports, with the ultimate goal of providing an independent report on the appropriateness of financial statements. **Tax services** provide help in preparing and filing of tax returns and the rendering of advice on the tax consequences of alternative actions. Consulting services can vary dramatically and include such diverse activities as information systems engineering and evaluation of production methods.

Many accountants are privately employed by small and large businesses (i.e., industry accounting) and nonprofit agencies (such as hospitals, universities, and charitable groups). They may work in areas of product costing and pricing, budgeting, and the examination of investment alternatives. They may serve as **internal auditors**, who look at controls and procedures in use by their employers. Objectives of these reviews are to safeguard company resources and assess the reliability and accuracy of accounting information and accounting systems. They may serve as in-house tax accountants, financial managers, or countless other occupations.

It probably goes without saying that many accountants also work in the governmental sector, whether at the local, state, or national level. Many accountants are employed at the Internal Revenue Service, General Accounting Office, Securities and Exchange Commission, and even the Federal Bureau of Investigation (see Table 2.3).

Table 2.3: Examples of careers in accounting

Career Types	Example Titles
Public-sector accounting	Audit and assurance services Tax preparation and planning Business consulting and systems design
Private-sector accounting	Staff accountant Controller Chief financial officer Tax manager Information technology manager Internal auditor
Federal government	Internal Revenue Service General Accounting Office Securities and Exchange Commission Federal Bureau of Investigation
Nonprofit and state/local governmental sector	Staff accountant Tax auditor Chief accounting officer/director Budget officer

2.5 The Importance of Ethics

Investors and creditors greatly rely on financial statements in making their investment and credit decisions. It is imperative that the financial reporting process be truthful and dependable. Accountants are expected to behave in an entirely ethical fashion. To help ensure integrity in the reporting process, the profession has adopted a code of ethics to which its licensed members must adhere. In addition, checks and balances via the audit process, governmental oversight, and the ever-vigilant plaintiff's attorney all serve a vital role in providing additional safeguards against the errant accountant. Those who are preparing to enter the accounting profession should do so with the intention of behaving with honor and integrity. Others will likely rely on accountants in some aspect of their personal or professional lives. They have every right to expect those accountants to behave in a completely trustworthy and ethical fashion. After all, they will be entrusting them with financial resources and confidential information.

Being ethical can sometimes be more challenging than you might presume. Accounting tasks naturally relate to money. This is especially true for public companies that have share prices prone to fluctuation based on reported income numbers. Sometimes millions of dollars are ultimately at stake based on what the accountants ultimately report. It is easy for accountants to fall into a trap of trying to cover what is seen as a temporary shortfall in income by some type of accounting gimmick. These stories usually end badly because participants tend to get sucked into an ever-worsening pattern of financial deception. In retrospect, participants in these schemes usually report that they initially acted in haste and under pressure. Nevertheless, the consequences tend to be career ending and worse. You must prepare yourself for ethical challenges in advance, so you can be firm and ready to act in an appropriate manner at all times. Accountants are fiduciaries for others and must act accordingly.

In closing, many students cannot envision themselves as accountants. That's okay. There are two important things to remember. First, accountants often move on to significant business leadership roles. This is true because their accounting training and experience provide the foundation for understanding and being successful in business. Second, people in business often remark that they wish they had studied more and knew more about accounting. In business, they quickly discover that accounting knowledge is essential—indeed paramount. Accounting truly is the language of business.

Key Terms

assets The economic resources of the entity that include such items as cash, accounts receivable (amounts owed to a firm by its customers), inventories, land, buildings, equipment, and even intangibles such as patents and other legal rights and claims.

auditing The examination of transactions and systems that underlie an organization's financial reports, with the ultimate goal of providing an independent report on the appropriateness of financial statements.

balance sheet A basic financial statement that reveals the assets, liabilities, and equity of a business at a particular time.

certified public accountant (CPA) A license issued by states that allows an accountant to specialize in public accounting.

comparability The ability to make relative assessments of companies.

consistency A concept that relates performance assessments over time.

dividends Distributions to shareholders as a return on their investment.

expenses The costs incurred in the process of producing revenues.

fair value An assessment based on current worth.

financial accounting Targeted toward reporting financial information about a business to external users such as the owner(s) and creditors.

Financial Accounting Standards Board (FASB) A private-sector group primarily responsible for developing the rules that form the foundation of financial reporting.

Governmental Accounting Standards Board (GASB) An independent organization that establishes and improves standards for financial reporting by local, state, and federal entities.

historical cost The concept that it is best to report certain financial statement elements at amounts that are tied to objective and verifiable past transactions.

income The enhancement to the business as a result of providing goods and services to its customers; mathematically, it is the result of subtracting expenses from revenues.

income statement A statement that reports income for a particular time period.

internal auditors Those professionals who look at controls and procedures in use by their employer.

International Accounting Standards Board (IASB) The international counterpart to the FASB; the IASB and FASB work cooperatively on many projects.

international financial reporting standards (IFRS) The effort to establish consistency in global financial reporting.

liabilities The amounts owed to others, such as obligations to loans, extensions of credit, and other debts that occur in the normal course of business.

managerial accounting Information intended to serve the specific needs of management.

net assets Another term for owner's equity.

owner's equity The owner's "interest" in the business; the equivalent to assets minus liabilities.

relevance The degree that accounting information bears on the decision process, primarily by providing timely feedback on an enterprise's financial condition and performance.

reliability The degree that accounting information is truthful and free from bias, or neutral.

retained earnings Earnings of a business that are not distributed.

revenues The gross inflows from customers.

statement of retained earnings A statement that builds a bridge between the retained earnings that existed at the beginning and end of a particular period.

statement of stockholders' equity An expanded statement that explains not only the periodic change in retained earnings but also shows all other sources of changes in equity.

tax services Provide help in preparing and filing of tax returns and the rendering of advice on the tax consequences of alternative actions.

Review Questions

The following questions relate to several issues raised in the chapter. Test your knowledge of these issues by selecting the best answer. (The odd-numbered answers appear in the answer appendix.)

1. The principle of historical cost
   a. holds that acquisitions of goods and services should be entered in the accounting records at acquisition cost.
   b. results in the development of subjective financial statements.
   c. is ideal for use in periods of high inflation.
   d. is not acceptable when constructing general-purpose financial statements.

2. Miller's Clinic had owner's equity of $32,000 on January 1, 20X2. During January, owner investments and withdrawals amounted to $15,000 and $9,000, respectively. In addition, the company generated revenues of $50,000 and expenses of $48,000. What was the amount of owner's equity on January 31?
   a. $8,000
   b. $36,000
   c. $40,000
   d. $58,000

3. John Davis recently withdrew $1,000 cash from the Davis Health Services, a sole proprietorship. This transaction would
   a. decrease both assets and liabilities.
   b. decrease both assets and owner's equity.
   c. decrease assets and increase owner's equity.
   d. increase both assets and owner's equity.

4. A company's ending accounts receivable balance and the period's advertising expense would be found on which financial statements, respectively?
   a. balance sheet and statement of owner's equity
   b. balance sheet and income statement
   c. income statement and balance sheet
   d. income statement and statement of owner's equity

5. X Company had revenues, expenses, owner investments, and owner withdrawals of $45,000, $35,000, $4,000, and $1,000, respectively. What was the firm's net income?
   a. $9,000
   b. $10,000
   c. $13,000
   d. $14,000

6. How does financial accounting differ from managerial accounting?

7. What are several limitations of accounting information?

8. Paul Martin is contemplating an investment in the Howard Health Clinic. He has secured the firm's audited financial statements, which have been examined by a certified public accountant. How can Martin be satisfied that the statements do not present false and incorrect information to purposely mislead investors?

9. Discuss the use of historical cost in the accounting process. Why is historical cost used, and what is one of its chief limitations?

10. Consider the income statement, the statement of owner's equity, and the balance sheet. Which of these statements cover(s) a period of time as opposed to a specific date?

Exercises

1. **Basic concepts**. Sam's Medical Equipment specializes in the sale of medical equipment and accessories. Identify the items that follow as an asset (A), liability (L), revenue (R), or expense (E) from the firm's viewpoint.

   a. the inventory of medical supplies owned by the company
   b. monthly rental charges paid for clinic space
   c. a loan owed to Citizens Bank
   d. new computer equipment purchased to handle daily record keeping
   e. daily sales made to patients
   f. amounts due from insurers
   g. land owned by the company to be used as a future store site
   h. weekly salaries paid to clinic staff

2. **Basic computations**. The following selected balances were extracted from the accounting records of Rossi Medical Equipment on December 31, 20X3:

Accounts payable	$ 3,200	Interest expense	$ 2,500
Accounts receivable	14,800	Land	18,000
Auto expense	1,900	Loan payable	40,000
Building	30,000	Tax expense	3,300
Cash	7,400	Utilities expense	4,100
Fee revenue	56,900	Wage expense	37,500

   a. Determine Rossi's total assets as of December 31.
   b. Determine the company's total liabilities as of December 31.
   c. Compute 20X3 net income or loss.

3. **Impact of business transactions**. The following items describe the impact of a business transaction or event on the components of the accounting equation. Present an example of a transaction or event that correctly matches the described impact.

   a. Increase an asset and increase a liability.
   b. Increase one asset and decrease another asset.
   c. Increase an asset and increase owner's equity from a transaction or event not related to income-producing activities.
   d. Increase an asset and increase owner's equity from a transaction or event related to income-producing activities.
   e. Decrease an asset and decrease a liability.
   f. Decrease an asset and decrease owner's equity from a transaction or event not related to income-producing activities.

4. **Analysis of transactions**. Set up the following headings across a piece of paper:

   Assets = Liabilities + Owner's Equity

   Indicate the effect of each of the following transactions on total assets, liabilities, and owner's equity:
   a. Processed a $5,000 cash withdrawal for the owner.
   b. Recorded the receipt of May's utility bill, to be paid in June.
   c. Provided services to patients on account.
   d. Paid the current month's advertising charges.
   e. Purchased a $27,000 vehicle by paying $5,000 down and securing a loan for the remaining balance.
   f. Received $11,000 cash from the owner as an investment in the business.
   g. Returned a new computer and printer purchased earlier in the month on account. The bill had not as yet been paid.
   h. Paid the utility bill recorded previously in part (b).

5. **Accounting equation; analysis of owner's equity**. Medical Equipment Repair revealed the following financial data on January 1 and December 31 of the current year.

	Assets	Liabilities
January 1	$45,000	$20,000
December 31	49,000	31,000

   a. Compute the change in owner's equity during the year by using the accounting equation.
   b. Assume that there were no owner investments or withdrawals during the year. What is the probable cause of the change in owner's equity from part (a)?
   c. Assume that there were no owner investments during the year. If the owner withdrew $17,000, determine and compute the company's net income or net loss. Be sure to label your answer.
   d. If owner investments and withdrawals amounted to $13,000 and $2,000, respectively, determine whether the company operated profitably during the year. Show appropriate calculations.

6. **Balance sheet preparation**. The following data relate to Preston Clinic as of December 31, 20XX:

Building	$44,000	Accounts Receivable	$24,000
Cash	17,000	Loan Payable	30,000
J. Preston, Capital	65,000	Land	21,000
Accounts Payable	?		

Prepare a balance sheet in good form as of December 31, 20XX.

7. **Income statement concepts**. Evaluate the following comments as being true or false. If the comment is false, briefly explain why.
   a. An income statement reveals the net income or net loss of an entity for a period of time as opposed to a specific date.
   b. Withdrawals are properly classified as an expense of doing business.
   c. If a company has $50,000 of revenues for March, it stands to reason that cash receipts for March must total $50,000.
   d. If expenses exceed revenues, a net loss has been generated.
   e. A computer acquired late in the year for use in the business should be disclosed on a firm's income statement.

8. **Financial statement relationships**. The following information appeared on the financial statements of the Johnson's Medical Clinic:

Income statement	
Total expenses	$ 64,900
Net income	7,200
Statement of owner's equity	
Beginning owner's equity balance	$113,200
Owner withdrawals	61,300
Ending owner's equity balance	70,800
Balance sheet	
Total liabilities	$ 97,000

By picturing the content of and the interrelationships among the financial statements, determine the following:
a. total revenues for the year.
b. total owner investments.
c. total assets.

9. **Financial statement presentation**. The accounting records of Robson's Healthcare revealed the following selected information for the year ended December 31, 20X6.

Cash investments by the owner	$ 59,000
Services rendered to patients	86,000
Cash withdrawals by the owner	12,000
Total year-end assets	177,800

Salaries, advertising, and utilities for the year totaled $68,500. The year-end asset total included a parcel of land that had cost the company $45,000. Robson's accountant used this amount for valuation purposes rather than the land's current market value of $75,000 (as determined by a recent real estate appraisal).

a. Determine the net income to be disclosed on the company's income statement.
b. Compute the increase or decrease in owner's equity during 20X6. On which financial statement would this information appear?
c. Determine and justify the proper valuation for Robson's year-end assets.

Problems

1. **Identification of transactions**. The following tabulation summarizes several transactions of the Hartford Healthcare Company:

	Assets				Liabilities		Owner's Equity
	Cash	+ Accounts Receivable	+ Computer	=	Accounts Payable	+	(Investments − Withdrawals) + (Revenues − Expenses)
	$5,000	$13,000	$29,000		$17,000		$30,000
Balances							
a.	−800						−800*
b.	+1,900	−1,900					
c.	−2,000						−2,000
d.	−3,000		+10,000		+7,000		
e.		+1,500					+1,500*
f.			+2,500				+2,500
g.					+900		−900*
	$1,100	$12,600	$41,500		$24,900		$30,300

Transactions in the Owner's Equity column designated with an asterisk (*) were caused by the company's income-producing activities. The $2,000 and $2,500 figures are unrelated to such activities.

Instructions

Write a brief explanation of each transaction.

2. **Basic transaction processing**. On November 1 of the current year, Dr. Richard Parker established a sole proprietorship. The following transactions occurred during the month:

    1: Received $19,000 from Parker as an investment in the business.

    2: Paid $9,000 to acquire a used minivan.

    3: Purchased $1,800 of office furniture on account.

    4: Rendered $2,100 of consulting services on account.

    5: Paid $300 of repair expenses.

    6: Received $800 from insurers who were previously billed in item 4.

    7: Paid $500 on account to the supplier of office furniture in item 3.

    8: Received a $150 electric bill, to be paid next month.

    9: Processed a $600 withdrawal for Parker.

    10: Received $250 from patients for services rendered.

    11: Returned a $450 office desk to the supplier. The supplier agreed to reduce the balance due.

Instructions

a. Arrange the following asset, liability, and owner's equity elements of the accounting equation: Cash, Accounts Receivable, Office Furniture, Van, Accounts Payable, Investments/Withdrawals, and Revenues/Expenses.
b. Record each transaction on a separate line. After all transactions have been recorded, compute the balance in each of the preceding items.
c. Answer the following questions for Parker:

    (1) How much does the company owe to its creditors at month-end? On which financial statement(s) would this information be found?
    (2) Did the company have a "good" month from an accounting viewpoint? Briefly explain.

3. **Statement preparation**. The following information is taken from the accounting records of Grimball Cardiology at the close of business on December 31, 20X1.

Accounts payable	$ 14,700	Surgery Revenue	$175,000
Surgical expenses	80,000	Cash	60,000
Surgical equipment	37,000	Office Equipment	118,000
Salaries expense	30,000	Rent Expense	15,000
Accounts receivable	135,000	Loan Payable	10,300
Utilities expense	5,000		

All equipment was acquired just prior to year-end. Conversations with the practice's bookkeeper revealed the following data:

Rose Grimball, capital (January 1, 20X1)	$300,000
19X1 owner investments	2,000
19X1 owner withdrawals	22,000

Instructions

a. Prepare the income statement for Grimball Cardiology in good form.
b. Prepare a statement of owner's equity in good form.
c. Prepare Grimball's balance sheet in good form.

4. **Transaction analysis and statement preparation**. The transactions that follow relate to Frisco Medical Center for March 20X1, the company's first month of activity.

   3/1: Received $20,000 cash from Joanne Burton, the owner, as an investment in the business.

   3/4: Rendered $2,400 of services on account.

   3/7: Acquired a small parcel of land by paying $6,000 cash.

   3/12: Received $700 from an insurer, who was billed previously on March 4.

   3/15: Paid $800 to the *Journal Herald* for advertising that ran during the first half of the month.

   3/18: Acquired $9,000 of equipment from Miller Medical Equipment by paying $7,000 down and agreeing to remit the balance owed within the next 2 weeks.

   3/22: Received $300 cash from clients for services performed on this date.

   3/24: Paid $1,500 on account to Miller Medical Equipment in partial settlement of the balance due from the transaction on March 18.

   3/28: Rented a car from United Car Rental for use on March 28. Total charges amounted to $75, with United billing Frisco for the amount due.

   3/31: Paid $900 for March wages.

   3/31: Processed a $600 cash withdrawal from the business for Joanne Burton.

Instructions

a. Determine the impact of each of the preceding transactions on Frisco's assets, liabilities, and owner's equity. Use the following format:

Assets			=	**Liabilities**	+	**Owner's Equity**	
Cash	Accounts Receivable	Land Equipment		Accounts Payable		(+) Investments (–) Withdrawals	(+) Revenues (–) Expenses

Record each transaction on a separate line. Calculate balances only after the last transaction has been recorded.

b. Prepare an income statement, a statement of owner's equity, and a balance sheet in good form.

5. **Financial statement preparation**. On October 1, 20X6, Susan Thompson opened Thompson Nursing Services, a sole proprietorship. Susan began operations with $50,000 cash, 60% of which was acquired via an owner investment. The remaining amount was obtained from a bank loan. A review of the accounting records for October revealed the following:

   - Asset purchases: van, $16,000; office equipment, $4,000; and furnishings, $17,000. These amounts were paid in cash except for $2,100 that is still owed for the furnishings acquisition.
   - Services performed: total billings on account, $18,300. Patients have remitted a total of $14,200 in settlement of their balances due.
   - Expenses incurred: salaries, $8,700; advertising, $2,500; taxes, $150; postage, $1,800; utilities, $100; interest, $450; and miscellaneous, $200. These amounts had been paid by month-end with the exception of $700 of the advertising expenditures.

   Further information revealed that Thompson withdrew $5,500 of cash from the business on October 31.

Instructions

a. Prepare an income statement for the month ending October 31, 20X6.
b. Prepare a statement of owner's equity for the month ending October 31, 20X6.
c. Prepare a balance sheet as of October 31, 20X6.