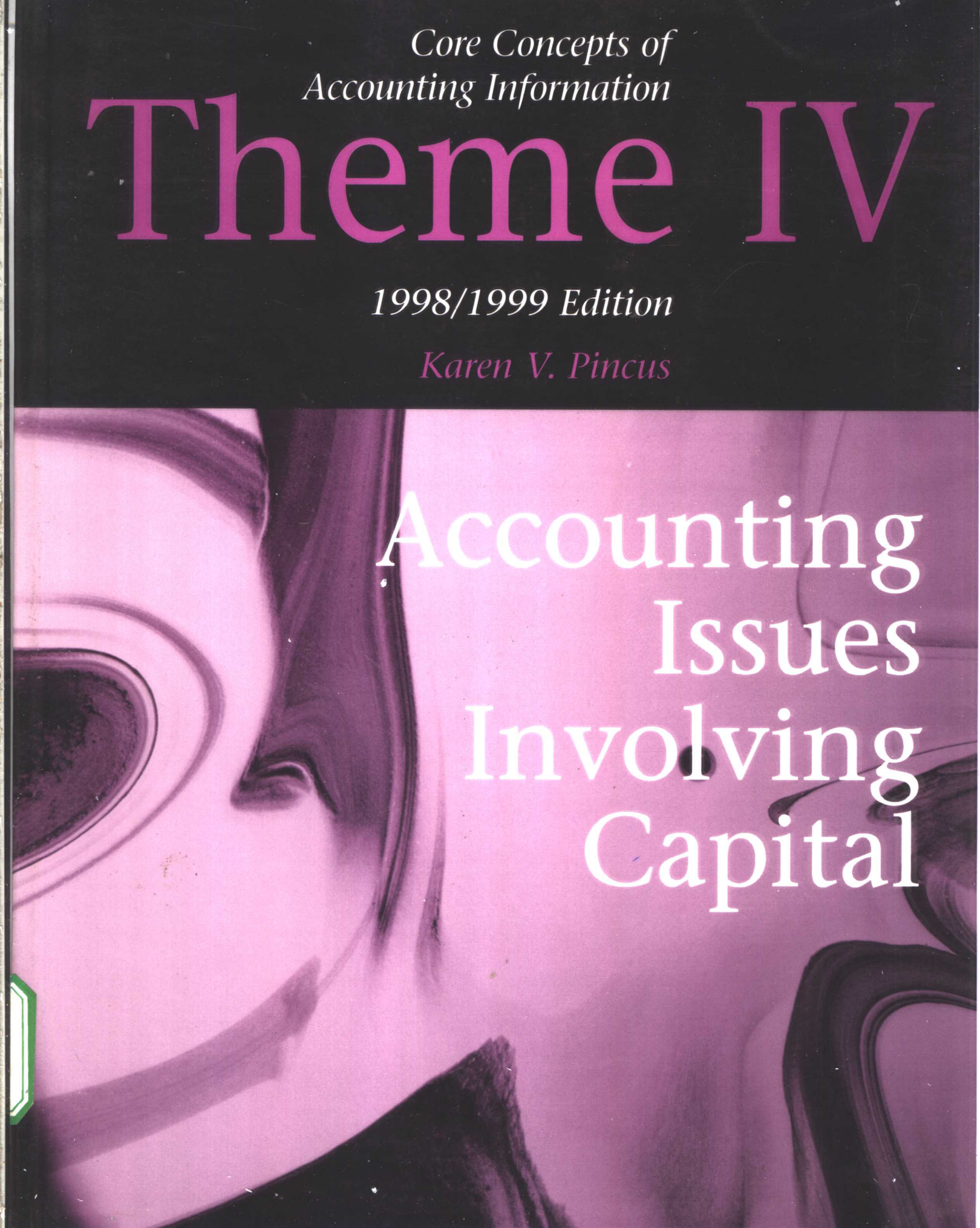


*Core Concepts of  
Accounting Information*

# Theme IV

*1998/1999 Edition*

*Karen V. Pincus*



Accounting  
Issues  
Involving  
Capital

# COMPUTERIZED ACCOUNTING

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## PREFACE

After your students learn the fundamental principles and concepts of accounting, what's next? A logical next step is to build on these understandings by applying them to real world technology. *Computerized Accounting* is a comprehensive textbook and software program that will help your accounting students make a smoother transition from the classroom to the workplace.

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## MAJOR CHANGES IN THE TEXTBOOK ▼

The textbook includes significant enhancements to facilitate the learning process. These changes are the result of invaluable feedback provided by numerous instructors. A description of these new features appears below.

- **NEW Expanded Coverage**—Two new chapters explain how to use the integrated inventory system and plant asset register built into the software. A comprehensive discussion addresses the issues and concepts involved in maintaining an inventory database. The textbook also includes expanded coverage of the integrated bank reconciliation tool and the graphs (charts) incorporated into the software.
- **NEW Spreadsheets**—The two chapters on spreadsheets teach your students how to enter formulas, format and copy data, print a worksheet, modify financial reports exported by the accounting software, and prepare charts. The text takes your students step by step through the process of analyzing a problem and building a spreadsheet from scratch using *Microsoft Works* and *ClarisWorks*.
- **NEW MacInTax**—This chapter introduces basic tax concepts using personal income tax forms as a model. The chapter also expands and

*Core Concepts of Accounting Information*  
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*Core Concepts of Accounting Information* is organized into 4 broad themes:

- Theme I:**    *The Users/Uses of Accounting Information*
- Theme II:**   *Accounting Issues Involving Income and Cash Flows*
- Theme III:**  *Accounting Issues Involving Economic Resources*
- Theme IV:**  *Accounting Issues Involving Capital*

Each theme looks at a variety of topics that cut across the major functional areas of accounting--financial accounting, managerial accounting, systems, tax and auditing. Examples from business, non-profit and government organizations--both domestic and international--are used throughout the themes.

Each theme is further divided into modules that follow the same organizational pattern across the themes:

- ◆ The first module of each theme provides an introduction to the theme, describing the key points to be covered and presenting needed terminology.
- ◆ The remaining modules explore the topics of the theme from the perspective of a particular user group for accounting information: management, owners and creditors, government and other users.
- ◆ Theme I also contains a final module on the environment of accounting that introduces the body of technical rules, laws, standards and guidelines in the 5 major functional areas of accounting and discusses how to research accounting questions and problems.

Instructors may choose to use full themes or may prefer to select one or more modules to cover in a course.

**Pagination**

*Core Concepts of Accounting Information* is divided into themes and modules, which different schools put together in a variety of ways.

How do you find material within your bound text? After this preface, pagination is of the form **I-2-3**, where the initial roman numeral indicates the theme, the middle number indicates the module within the theme, and the final number indicates the page within the module. Thus, page I-2-3 indicates Theme I, Module 2, page 3.



**CORE CONCEPTS OF ACCOUNTING INFORMATION**

**THEME IV: Accounting Issues  
Involving Capital**

**Karen V. Pincus**

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Note: Detailed tables of contents for each module appear at the front of the modules.

## **MODULE I: INTRODUCTION**

**1998-1999 edition**

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## **MODULE I: INTRODUCTION**

### **Estimated Time Budget**

<b><u>Task</u></b>	<b><u>Time Estimate</u></b>
Reading	90 - 120 minutes
Assignments	
Assignment IV-1-1	90 - 120 minutes
Assignment IV-1-2	30 - 60 minutes
Assignment IV-1-3	10 - 15 minutes
Assignment IV-1-4	120 - 180 minutes
Assignment IV-1-5	50 - 90 minutes
Assignment IV-1-6	30 - 60 minutes
Assignment IV-1-7	50 - 90 minutes
Assignment IV-1-8	90 - 120 minutes
Assignment IV-1-9	90 - 120 minutes
Assignment IV-1-10	20 - 40 minutes

*Note: These time estimates, like all the time budgets for this course, should be adjusted to suit your own learning style. Time estimates for assignments assume that readings were completed before attempting the assignments.*

## MODULE I: INTRODUCTION

*Business? It's quite simple--it's other people's money.*  
-- Alexandre Dumas (1824-1895), The Question of Money

All organizations--business, not-for-profit and government--need capital to operate and finance growth. The economic resources (assets) that an organization uses in operations or invests for the future may be financed by:

- ◆ **debt capital**--money borrowed from creditors, and/or
- ◆ **equity capital**--money obtained from reinvesting accumulated earnings in the organization or, in the case of a business organization, from selling an interest in the business to investors (owners). In the case of nonbusiness (nonprofit or government) organizations, which have no owners, the **fund balance** plays a role analogous to that of a business's equity interests.

Of course, when creditors and investors provide capital, they establish an interest in the assets of an organization. Debt financing gives rise to **liabilities**, or obligations to creditors. Equity financing gives rise to **equities**, or ownership interests. This relationship between the economic resources of an organization and its sources of capital is expressed succinctly in the accounting equation, one form of which is:

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

In this module, we'll take a look at the right-hand side of the accounting equation, considering the various types of liabilities and equities and the blurring line between debt and equity in modern capital markets.

### DEBT CAPITAL: LIABILITIES

*Credit is but a transfer of capital from hand to hand; it is generally, and naturally, a transfer to hands more competent to employ the capital efficiently in production.*

-- John Stuart Mill (1806-1873), Principles of Political Economy

Shakespeare may have said, "Neither a borrower nor a lender be," but the truth is that modern societies thrive on borrowing and lending. For business organizations, using money to make more money is a key goal. Borrowing and lending help achieve this economic goal. Capital is transferred from individuals

or organizations that have money and a desire to increase their return (the lenders) to businesses with ideas and opportunities for using money to earn a return (the borrowers). For example, a business may borrow money to expand operations to new locations that increase future profit potential.

For nonprofit and government organizations, borrowing and lending help achieve social goals. For instance, a government entity may borrow money to construct a new school building with an eye toward improving the region's future economic potential. When the school's graduates use their education to earn an income, taxes on that income will help repay the government's debt. Thus, borrowing and lending serve economic and social functions.

In a credit transaction, capital changes hands between a lender and borrower. The lender is left with an *asset*, a receivable from the borrower. The borrower is left with a *liability*, an obligation to the lender. The borrower is willing to take on this liability--which, after all, requires settlement in the future--because of the desire for capital to take advantage of present opportunities or meet current needs. In its Statement of Financial Accounting Concepts #6, *Elements of Financial Statements*, the Financial Accounting Standards Board described the economic role of liabilities as one that hinges on time--in particular, the borrower's ability to use capital today while delaying settlement of an obligation into the future:

*Most liabilities stem from human inventions--such as financial instruments, contracts and laws--that facilitate the functioning of a highly developed economy...Liabilities facilitate the functioning of a highly developed economy primarily by permitting delay--delay in payment, delay in delivery, and so on.*

In this section, we'll look at some typical liabilities, using 2 airlines (US Airways and Air Canada) as examples. Both are major carriers and both have been suffering from industry-wide economic pressures. From 1990 to 1993, the airline industry experienced aggregate losses of \$15.6 billion, an amount greater than the industry's accumulated net income since commercial air travel was first offered 75 years earlier. Under these circumstances, capital needs become critical and "**servicing**" **debt** (making interest payments when due) can become difficult. From 1990 to 1992, 27 U.S. airlines and numerous non-U.S. airlines, including such giants as Pan American and TWA, filed for bankruptcy.

The pressures on the airline industry are particularly great because airlines are very capital intensive. To be competitive, airlines must have modern, efficient, reliable aircraft and terminal facilities. They must create and maintain information systems capable of providing real-time service to customers. They also need capital to pay operating costs such as leasing ticket counter space in airports, paying landing fees for the non-exclusive rights to use ramps, runways and other airport facilities, and paying expenses such as salaries and fuel costs. With such great need for capital, it is not surprising that the airline industry is a major user of both debt capital and equity capital.



In this section, we will discuss the sources of debt capital (and, in the following section, the sources of equity capital) for 2 airlines, US Airways and Air Canada. To begin, here is some background on these companies, including their experiences during the economic pressures from 1990-1993:

**US Airways Group, Inc.** US Airways first began operations in the late 1930s as All American Aviation, a Washington D.C.-based airmail service. The company was founded by pilot Richard duPont, a member of the same family that founded chemical giant E. I. du Pont de Nemours and Company. All American Aviation developed a system of hooks and ropes so its planes could drop off and pick up bags of mail without landing. Its "on the fly" system was so successful that the U.S. Army Air Corps adapted the method during World War II as a means to rescue pilots stranded in enemy territory.

The company operated as an airmail service until 1949, when it converted to passenger service operations. By the time it went public in 1978, it was a regional airline known as Allegheny Airlines. By 1979, as the company continued to expand its geographic operations, the name was again changed. The new corporate name was chosen after a survey asked passengers to rate Allegheny in comparison to other airlines, including a "ringer" that didn't exist. The "ringer," USAir, scored very well--even better than Allegheny Airlines--and the company had its new name, USAir, which changed to US Airways in 1997.

The company operated profitably through 1988, becoming one of the 10 largest U. S. airlines and expanding internationally, but ran into financial difficulties in 1989. Despite continuing efforts to reduce costs--including eliminating some flights, closing some facilities and reducing its workforce--the company suffered losses every year from 1989 through 1993 and still found itself with one of the highest costs per mile in the industry.

**Air Canada.** Air Canada has spent much of its life to date as a "Crown Corporation," a government enterprise. In 1988, the company was privatized and it began to operate as a Canadian business corporation. At the start of the 1990s, rising fuel costs, the threat of terrorism as a result of tensions in the Middle East, and economic slowdowns created many problems for the airline industry, so Air Canada ran into financial difficulties.

The airline operated at a loss in 1990 and began a restructuring plan, including flight reductions and a 12% staff reduction. Air Canada also sold its enRoute Card, Inc. subsidiary, then the world's largest airline-operated credit card, in order to reduce its need for **working capital** (funds available to meet short-term obligations). Credit card operations require significant amounts of working capital because competitive conditions are such that the credit card company must be able to pay money to retailers for the charged purchases quickly, but the consumers who use the credit card must be given a longer time to pay their bills (including finance charges).

As the industry continued to suffer from 1991 to 1993, Air Canada was hard hit, particularly since the Canadian airline industry was still adjusting to recent privatization. Under government operation, the industry had been structured in a way that wasn't efficient for the harshly competitive conditions of the 1990s. Air Canada experienced continuing losses in 1991, 1992 and 1993.

**The Airline Industry: 1994 to 1998.** Globally, the airline industry began to recover in 1994, operating above the break-even point (with global profits of \$1.8 billion) for the first time since 1989. Since airlines have high fixed costs and low variable costs, even small moves above break-even volumes can have a substantial impact on profits. London's NatWest Securities has estimated the airline industry breaks even when, on average, flights are 66.5% full. But, with a relatively small volume increase to a 70% load-factor, industry profits grow to over \$13 billion. On the other hand, small moves below break-even volume can create severe cash flow pressures and make it difficult to meet liabilities.

It was in 1994 that the fortunes of US Airways and Air Canada began to diverge. Air Canada's 1994 net income soared to \$129 million, the second-best year in the company's history. But US Airways, with higher operating costs per mile than other major airlines and the misfortune of 2 major crashes during 1994, suffered a loss of \$685 million. The company's auditors expressed substantial doubt about the airline's ability to continue operating as a going concern, while management worked to stem losses by reducing the fleet and cutting unprofitable routes.

Industry profits further improved from 1995 to 1997, when profits set a new record at \$4.5 billion. Air Canada also had 3 profitable years, culminating in 1997 net income of \$427 million, the strongest position of its public company lifetime. In 1995, US Airways reported its first annual profit in 7 years, followed by a stronger performance in 1996 and 1997. But its costs still are much higher (at about 12 cents a mile) than its competitors' costs (typically under 9 cents a mile), which makes US Airways more vulnerable to any economic slowdown and a target for acquisition by a financially stronger airline.

The liabilities of US Airways and Air Canada may be found in Figures IV-1-1 and IV-1-2 on the following pages. As you look at these figures, remember that one major source of capital is debt--borrowing funds that must later be repaid, usually with interest. When you look at the balance sheets of US Airways and Air Canada, you will see that both airlines count among their creditors:

- ◆ their suppliers,
- ◆ their customers,
- ◆ their employees,
- ◆ taxing authorities, and
- ◆ banks and other lenders.

Next, we'll take a closer look at each of these creditor groups.

Figure IV-1-1  
**US Airways Group, Inc. Consolidated Balance Sheets**

December 31,	1997	1996
<i>(dollars in millions, except per share amounts)</i>		
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash	\$ 18	\$ 21
Cash equivalents	1,076	930
Short-term investments	870	636
Receivables, net	300	337
Materials and supplies, net	226	249
Deferred income taxes	147	—
Prepaid expenses and other	140	137
Total Current Assets	2,777	2,310
<b>Property and Equipment</b>		
Flight equipment	5,221	5,202
Ground property and equipment	877	1,108
Less accumulated depreciation and amortization	(2,528)	(2,470)
	3,570	3,840
Purchase deposits	155	78
Total Property and Equipment, Net	3,725	3,918
<b>Other Assets</b>		
Goodwill, net	616	495
Other intangibles, net	371	283
Investment in marketable equity securities	190	—
Deferred income taxes	270	—
Other assets, net	423	525
Total Other Assets	1,870	1,303
	<b>\$ 8,372</b>	<b>\$ 7,531</b>
<b>LIABILITIES &amp; STOCKHOLDERS' EQUITY (DEFICIT)</b>		
<b>Current Liabilities</b>		
Current maturities of long-term debt	\$ 186	\$ 84
Accounts payable	323	439
Traffic balances payable and unused tickets	707	715
Accrued aircraft rent	509	511
Accrued salaries, wages and vacation	311	423
Other accrued expenses	492	676
Total Current Liabilities	2,528	2,848
<b>Long-Term Debt, Net of Current Maturities</b>	<b>2,426</b>	<b>2,616</b>
<b>Deferred Credits and Other Liabilities</b>		
Deferred gains, net	332	360
Postretirement benefits other than pensions, non-current	1,173	1,093
Non-current employee benefit liabilities and other	830	439
Total Deferred Credits and Other Liabilities	2,335	1,892
<b>Commitments and Contingencies</b>		
<b>Redeemable Cumulative Convertible Preferred Stock</b>		
Series H, no par value, 358,000 shares issued and outstanding	358	358
Series F, no par value, 30,000 shares issued and outstanding as of December 31, 1996	—	300
Series T, no par value, 10,000 shares issued and outstanding as of December 31, 1996	—	101
<b>Stockholders' Equity (Deficit)</b>		
Series B cumulative convertible preferred stock, no par value, 4,263,000 depository shares issued and outstanding as of December 31, 1996	—	213
Common stock, par value \$1 per share, authorized 150,000,000 shares, issued and outstanding 91,482,000 and 64,306,000 shares, respectively	91	64
Paid-in capital	1,906	1,387
Retained earnings (deficit)	(1,280)	(2,118)
Common stock held in treasury, at cost, 39,929 shares as of December 31, 1997	(3)	—
Deferred compensation and other, net of tax	(93)	(130)
Unrealized gain on securities, net of tax	104	—
Total Stockholders' Equity (Deficit)	725	(584)
	<b>\$ 8,372</b>	<b>\$ 7,531</b>

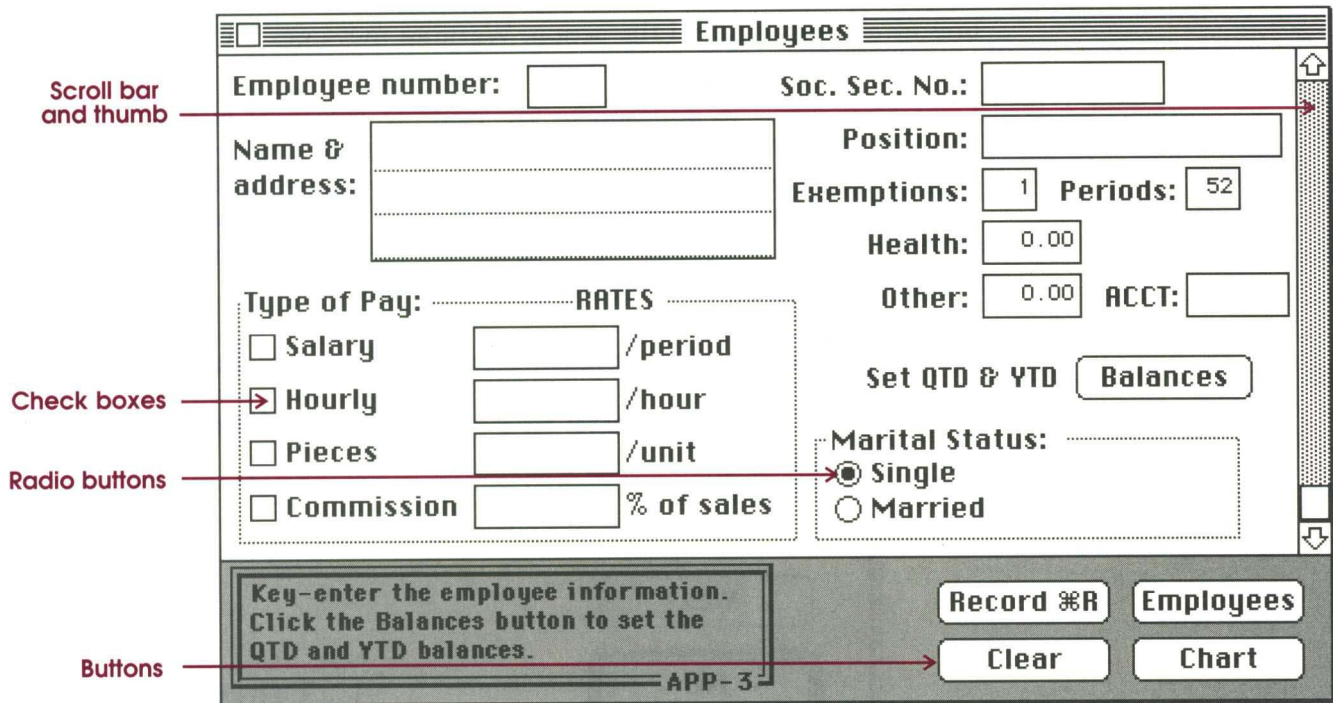
Figure IV-1-2  
**Air Canada Consolidated Statement of Financial Position**

(in millions)

December 31

	1997	1996
<b><u>Assets</u></b>		
<b>Current</b>		
Cash and short-term investments (note 1d)	\$ 650	\$ 455
Accounts receivable	467	387
Spare parts, materials and supplies	225	197
Prepaid expenses	17	20
Deferred income taxes	35	—
	<u>1,394</u>	<u>1,059</u>
<b>Property and equipment (note 2)</b>	2,817	2,819
<b>Deferred charges (note 3)</b>	1,447	1,118
<b>Investments and other assets (note 4)</b>	333	445
	<u><b>\$ 5,991</b></u>	<u><b>\$ 5,441</b></u>
<b><u>Liabilities</u></b>		
<b>Current</b>		
Accounts payable and accrued liabilities	\$ 668	\$ 615
Advance ticket sales	400	270
Current portion of long-term debt	71	226
	<u>1,139</u>	<u>1,111</u>
<b>Long-term debt and subordinated perpetual debt (note 5)</b>	2,739	2,847
<b>Other long-term liabilities</b>	218	177
<b>Deferred credits (note 7)</b>	460	321
	<u>4,556</u>	<u>4,456</u>
<b><u>Shareholders' Equity</u></b>		
<b>Convertible debentures (note 8)</b>	201	186
<b>Share Capital (note 9)</b>	1,063	1,056
<b>Retained earnings (deficit)</b>	171	(257)
	<u>1,435</u>	<u>985</u>
	<u><b>\$ 5,991</b></u>	<u><b>\$ 5,441</b></u>





**Figure 1-9** Window Containing a Scroll Bar, Radio Buttons, and Check Boxes

**Scroll Bars.** Throughout the program, information of all types is displayed in lists. The chart of accounts, journal transactions, and files on your data diskette are examples of lists. As the quantity of information increases for a specific item, all the data cannot be displayed on the screen at the same time. Therefore, the program uses a control, called a **scroll bar**, that allows you to scroll through the information in a list.

A scroll bar, as shown in Figure 1-9, always appears on the right side of a window or list box. Arrows are attached to each end of the scroll bar. A position indicator, called the **thumb**, appears within the bar to show you where you are in the list. For example, if the last item in the list is highlighted, the thumb appears at the bottom of the scroll bar.

Your Macintosh may be connected to a standard or extended keyboard. Only the extended keyboard includes these special keys. The **PgUp** key displays the next page above the currently displayed data, and **PgDn** displays the items below. The **Up** (↑) and **Down** (↓) arrow keys scroll the list one item at a time. The **Home** and **End** keys highlight the first and last items in a list, respectively.

**Buttons.** Another means to control the actions performed by the accounting software is through the use of buttons. A **button** performs various functions such as posting an entry, displaying the chart of accounts, or confirming a decision. The number of buttons varies, depending on the function being performed.

The window in Figure 1-9 shows four buttons: *Record*, *Employees*, *Clear*, and *Chart*. The action listed on the button is performed by using the mouse to click on it. In some instances, pressing the Return key selects a button. Whenever a button is highlighted with a thick border, pressing Return