

# Confusion Points in Principles of Financial Accounting and Clinical Approaches to Clearing Them

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## Abstract

‘Principles of financial accounting’ is generally the first accounting class that is required of all business majors, not to mention accounting majors. However, often found is that significant percentage of those who passed the class still don’t have clear knowledge of even the basics of the class. This has become a more serious issue for accounting majors, because some accounting majors graduated without having clear knowledge of the basics of accounting that they should have learned from this class and faced the consequences of it after graduation. From the teaching experiences of the author, this study found the most common confusion points in the class, which have caused the issue, and presented clinical approaches to the confusion points that have been proven significantly effective clearing them.

**Keywords:** Confusion points, Basics of accounting, Clinical approaches, Principles of financial accounting, Introductory financial accounting, Accounting education

## 1. Introduction

Whether the US economy seems to be recovering or seems to be still in downturn, accounting majors seem to have a relatively favorable job market for them. For this reason, many students declare accounting as their major and start the first accounting class, commonly titled ‘Principles of Financial Accounting,’ or ‘Introduction to Financial Accounting.’

From an instructor’s perspective of the first accounting class, it is common to see high percentage of students in the class fail the first and second exam and drop the class for the semester. Even for those who passed the introductory financial accounting class, it is found in

the next accounting class that significant percentage of them are not clear yet on the accounting equation, accounting cycle, and connections among the basic financial statements. Some of these students are further allowed to pass the following major accounting classes and to graduate without knowing the basics of accounting.

## **2. Literature Review**

After reviewing researches regarding the competence of accounting graduates, it is concluded that almost all the researches in this line are conducted on the assumption that the students who pass any of accounting classes know at least the basics of the class. The researches so far has explored how different teaching styles, different teaching materials, different deliveries of teaching, etc. affect the performance of students in accounting classes. Some other researches in this area have examined how the technical skill set the accounting graduates acquire would help get them employed upon graduation.

A research that addresses the lack of basic competence of accounting graduates is rare and difficult to find; so, the relevant personal experiences of current issue are presented next, instead.

## **3. Seriousness of the Issue**

It was the author' experiences that, while teaching at one school, accounting faculty and the dean of the college of business were called to a meeting with a hiring manager at a local CPA office who hired accounting graduates of the school. The hiring manager of the CPA office said that, after the office hired the accounting graduates of the school, they tested them with basic accounting questions but they failed the test by a surprising margin. Another experience by the author was that, while teaching at another school, a complaint from one of Big Four accounting firms was reported to the dean of college of business of the school. The complaint was that, after the accounting firm hired an accounting graduate of the college who got 4.0 accounting GPA, they soon found out that the accounting graduate lacked basic accounting knowledge and could not handle basic accounting tasks. It was also known to the accounting faculty of this business school that that was not the only one case of it. Both of the business schools were accredited by AACSB (The Association to Advance Collegiate Schools of Business) when the incidences happened.

These incidences can be reasoned by the fact that, for the past several years or longer, a large number of colleges and universities across the nation have been facing shrinking enrollment and consequences of it. In order to deal with the consequences of shrinking enrollment, academic departments and college units at the schools compete among themselves on their respective campuses in recruiting and retaining students of their majors, accounting department not being an exception to the competition for students.

Since the enrollment issue has been ongoing for a long term, it has become a driving force for faculty of accounting department not to fail significant percentage of students in their classes. Then, high passing rates in accounting classes tend to mean passing undeserving students to the next accounting class. After this pattern repeats from the very first accounting class throughout accounting curriculum, included in accounting graduates are those students who

are not so cut out for accounting major. This phenomenon will likely keep going spiral, if any measure to deal with it is not warranted.

#### **4. Purpose of the Paper**

In accounting education, the importance of the first accounting course cannot be overemphasized, because the foundation of accounting system is laid out in the first course and most of the following accounting courses are built upon it. In spite of the absolute importance of the course, this course is often taken in an unserious attitude during the freshman year, which is usually the starting point of the issue, staying not easily fixable later on.

In this paper, as an effort to address the issue, presented in the following section are the most common confusion points for students in the introductory financial accounting course, and, as for each confusion point, proposed next to it is a clinical approach to clearing the confusion point.

#### **5. Confusion Points**

The confusion points in the introductory financial accounting course are compiled from the author' teaching experiences of the course at different schools for the past ten years from 2008 to 2018. During the period, the author' own approaches to the confusion points were developed, applied, and modified until proven effective on most of students.

##### **Confusion Point 1: The Definition of Assets**

When students were asked to answer what assets mean in principles-of-managerial-accounting class, to which principles-of-financial-accounting is generally prerequisite, they said assets are liabilities plus stockholders' equity and that assets are cash, accounts receivable, inventory, equipment, etc. The students in the class remembered the accounting equation and were able to give examples of assets. However, when the students were asked to describe their understandings of assets other than the accounting equation and examples of assets, only a few of them could explain in their own words why the whole assets are divided into liabilities and stockholders' equity and what assets also mean as the sum of the two components in the accounting equation.

Further, students said that the definition of assets in a textbook is too scholastic and even vague that it doesn't help them to understand what assets are. Rather, the students said they can understand the textbook definition of assets after they know well what assets are. One of typical textbook definitions of assets is cited below as an example;

“Assets are resources a company owns or controls. These resources are expected to yield future benefits.” (Wild, J. J. et al. (2017). *Financial and Managerial Accounting*. New York, NY: McGraw-Hill Education)

Even worse for students, FASB (Financial Accounting Standards Board) defines assets as follows;

“Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.”

#### Clinical Approach to Confusion Point 1 (The Definition of Assets)

Because the definition of assets in a textbook is technically correct but practically not so helpful for students to understand the concept of assets, various clinical explanations or illustrations of assets have been put to test on students, and the following steps of explanations, illustrations, and reiteration is found to get the most students to understand what accounting is; what assets mean in accounting; and the concept of accounting equation.

##### Step 1

Simply speaking, ‘accounting’ is a record-keeping system of a company’s business transactions involving money. Any transaction not involving money is not to be recorded accounting-wise.

##### Step 2

The whole record-keeping system of accounting is built on the accounting equation: assets = liabilities + stockholders’ equity. So, this equation is the foundation of the whole accounting system.

##### Step 3

In order to understand what assets mean in accounting and why the accounting equation is set up that way, it takes plays with the equation. For this purpose, the best example to play with on the equation is a whole new company. So, let’s say a whole new company is just created that has now nothing but the company name.

##### Step 4

Because the company is new and has nothing, the company needs to raise some money and also needs to have some stuff (inventory) to sell, assuming it’s a merchandising company. Now, let’s say the company issued stock for \$10,000 cash, raising that amount of money, and got \$3,000 inventory from a wholesaler on account, having the inventory to sell in their possession. These transactions are recorded along the accounting equation as follows:

Assets	=	Liabilities	+	Stockholders’ Equity
\$10,000 Cash				\$10,000 Stock Issued
\$3,000 Inventory		\$3,000 Account Payable		

##### Step 5

Again, let’s see what the company got in their possession; they got \$10,000 cash and \$3,000 inventory. These things the company got in their possession to use them in their business are recorded as assets on one side of the equation. Next, let’s see how the company got those; the \$10,000 cash was raised through issuing stock, and the \$3,000 inventory was bought on account, to be paid for later. How the company got them are recorded respectively on the

other side of the equation. This way the accounting equation is in balance for every transaction recorded.

#### Step 6

As illustrated in Step 4 and rephrased in Step 5, assets are actual things valuable, such as cash, inventory, etc., that the company has in their possession in doing their businesses, whether the company gets the things on account, i.e. through debt (liabilities), or not.

#### Step 7

For the total value of assets, it is explained how much the company is liable to pay, 'liabilities,' and how much is not through liability, which is 'stockholders' equity.' The accounting equation is set up this way because, first, it is necessary to know and record what the company has in their possession (assets); second, for the total assets, the company should know and record how much the company is liable to pay (liabilities); and, third, it should be known and recorded how much is not liabilities (stockholders' equity). Assets, as the sum of liabilities and stockholders' equity (non-liabilities), mean the total value of what the company has in their possession for their business operations.

#### Step 8

After Steps 1 through 7, each component of accounting equation is summarized as follows;

Assets	=	Liabilities	+	Stockholders' Equity
All in Company's		In Asset, How Much		In Assets, How Much
Possession for		Company is Liable		is Not Liabilities
Business Operations		to Pay		

### Confusion Point 2: Stockholders' Equity in the Accounting Equation

As cited several times in Confusion Point 1, the general expression of accounting equation is: assets = liabilities + stockholders' equity. Through Confusion Point 1, it is clarified that assets are what in the company's possession for the company's business operations and that liabilities are how much the company is liable to pay in the assets. Thus, it is clear that assets and liabilities are the company's assets and the company's liabilities. However, stockholders' equity seems it is directly stockholders' equity, not the company's equity. What is correct on stockholders' equity is that that much of assets are not liabilities of the company but that that much of assets is the company's own equity, firstly, and, ultimately, that much of assets is stockholders' equity because the company is owned by stockholders. Although students understand that a company is an entity by itself, which is legally independent of and separate from stockholders, significant portion of students still think that stockholders' equity is directly owned by stockholders. Some textbooks call it 'equity' instead of 'stockholders' equity,' which is less misleading. By this reason, hereafter, equity is used in place of stockholders' equity.

### Confusion Point 3: Normal Balances of Accounts

Another common confusion point for students in learning the basics of accounting is to understand normal balances of accounts for assets, liabilities, and equity, and why normal

balances of those accounts are set up in that manner. In order to clear this confusion point, one big ‘T’ account is set up right below the accounting equation as follows:

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

Assets	Liabilities + Equity
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As shown above, the vertical line of the big ‘T’ account is set right below the equal sign (=) of the accounting equation, and the components of the equation are placed on the same side of the big ‘T’ account. Next, as shown below, three small ‘T’ accounts are separated from the big ‘T’ account for each of the components of the equation.

Assets	=	Liabilities	+	Equity
Assets		Liabilities		Equity

Now, these big and small ‘T’ account displacements have the visual effects that it is natural and normal to have balances on the sides of their ‘T’ accounts where the components of the equation are placed. This way of explanation of the concept of normal balances is not found in any of textbooks yet, but it is tested effective on students leaving little room for confusion.

The examples of transactions in Step 4 of Confusion Point 1 are placed into their respective small ‘T’ accounts as below;

Debit	Credit	Debit	Credit	Debit	Credit
Cash \$10,000		Inventory \$3,000	Account Payable \$3,000		Stock Issued \$10,000

After naming the left side of ‘T’ account debit and the right side credit, all the entries of transactions on the small ‘T’ accounts are put together back into one big ‘T’ account as shown below;

Debit	=	Credit
Cash \$10,000		Stock Issued \$10,000
Inventory \$3,000		Account Payable \$3,000

Furthermore, this way of illustrations has also gotten almost all the students in the course to understand double entry system (debit entry and credit entry for the same amount), and why the sum of debit entries should be equal to the sum of credit entries.

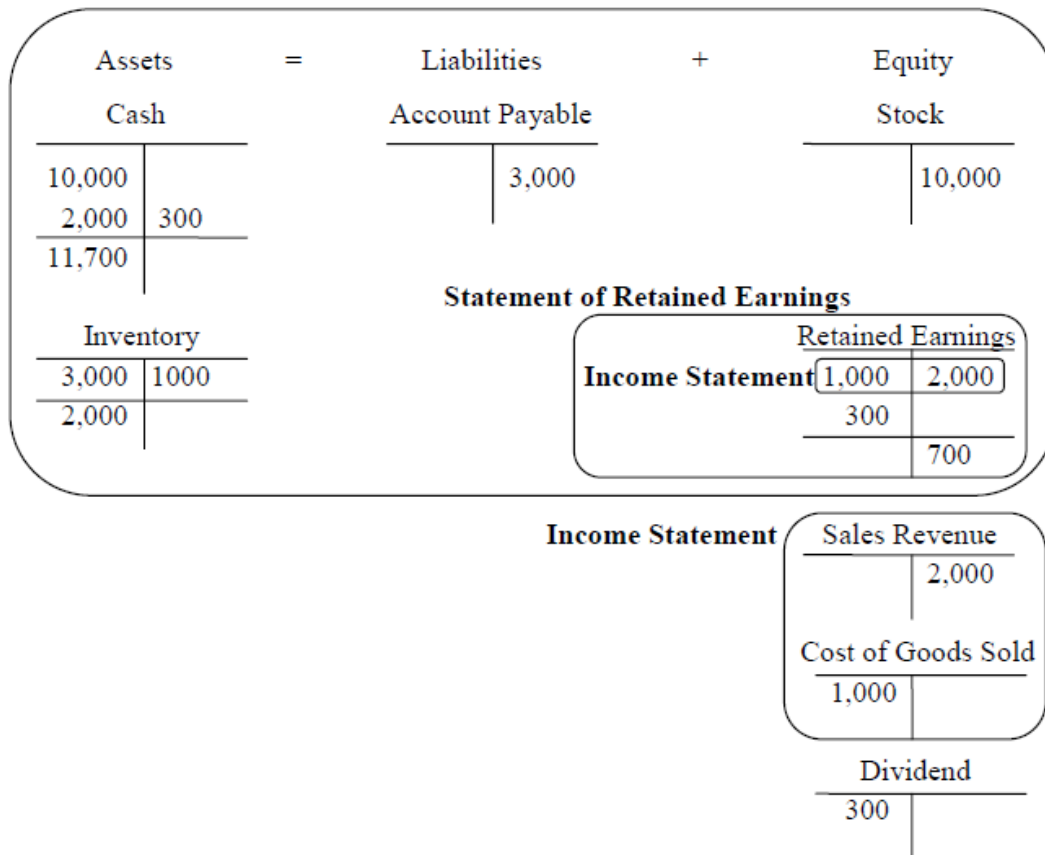
#### Confusion Point 4: Interrelationship among Financial Statements

The biggest confusion in the first financial accounting course is found to be with the interrelationship among three basic financial statements: income statement, statement of retained earnings, and balance sheet. In any textbook for this course, the linkage among these financial statements is shown by arrows between the statements. In the meanwhile, when the linkage of the financial statements is shown on a general ledger by using 'T' accounts, significantly higher percentage of students understood the interrelationship of the financial statements, because the relationship of the financial statements is shown at the source of the accounts for the statements. The way to show the interrelationship among the financial statements on a general ledger is as follows using the transactions in Confusion Point 1 and two additional transactions:

#### Additional Transactions:

- One third of the inventory was sold for \$2,000 cash.
- \$300 cash dividend was paid.

**Balance Sheet**



Departing from the common ways in textbooks to show the interrelationship among these three financial statements, the above way illustrates, through ‘T’ accounts, how income-statement accounts are incorporated onto the statement of retained earnings, and how the statement of retained earnings are then incorporated onto the balance sheet. Moreover, this way of illustration on the relationship between the income statement and the statement of retained earnings gives the idea in advance why and how the income-statement accounts and dividend account should be closed onto the statement of retained earnings before closing journal entries are entered on a general journal.

**6. Conclusion**

Top-tier schools would not have the issue of current paper because they have the power of student selection on a rolling basis. But, compared to the total number of higher education institutions in the United States, the number of top-tier schools is very small, and the rest of schools are the overwhelming majority of higher education institutions in the nation.

Those accounting graduates from non-top-tier schools who pass CPA (Certified Public Accountant) exam or any other professional exam in accounting pass the test of the current issue. But, again, the percentage of accounting graduates from non-top-tier schools who pass CPA exam or any other accounting professional exam is very small compared to the total number of accounting graduates from the schools.



In regard to the issue in the paper, AACSB accreditation for college unit and separate AACSB accreditation for accounting program are known to help the college and the department recruit and retain significantly more students, but doesn't help control the issue in this paper.

For these reasons, often, companies test accounting job candidates on basic accounting knowledge during interview process because the companies do not totally trust GPAs of their job candidates.

The current issue of the paper seems to continue and even likely go worse because the current circumstances the schools are in look so persistent in the foreseeable future. So, counter-measures to cope with this issue should be sought for before the significance of the issue continues or grows any further. One counter-measure to this issue would be to find a better way to teach the fundamental concepts and basics of financial accounting. Besides, if online classes are considered to be less effective than in-class instruction, finding a better way to explain the most important basics of financial accounting would be carrying out an added role when the classes are taught online.

So far, schools have devised and utilized a variety of ways to handle this issue, such as having tutors available for students, dividing the introductory financial accounting class into sub-sections, and so on, although those extrinsic approaches have not made significant effect on the issue.

Finding intrinsic approaches to the issue, the clinical approaches to the confusion points have been devised, experimented, and found effective in clearing the confusion points. Almost all of students' reactions to the approaches have converged on one point that the clinical approaches are simpler, more straightforward, and more intuitive than those in textbooks.

It is hoped that the clinical approaches of the paper to the common confusion points in the first accounting class help students make smooth transition to accounting concepts and make smooth progress learning accounting basics, which will then help ease the issue in question.

## **7. Further Researches**

It is probable that there are common confusion points in the other principles' courses in accounting, too. Those courses are principles of managerial accounting and principles of auditing. Serious confusion points in these principles' courses also prevent students from learning further in advanced courses of the areas, resulting in the similar consequences to those of principles of financial accounting. Thus, it is also worthwhile to find the serious common confusion points in these principles' courses of accounting and to present proven effective approaches to clearing them.

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