1 Accounting and the Business Environment

As you'll learn in this chapter, the accounting equation (Assets = Liabilities + Equity) IS the balance sheet.

SMART TOUCH LEARNING
Balance Sheet
May 31, 2013

Assets				Liabilities	
Current assets:				Current liabilities:	
Cash		$ 4,800		Accounts payable	$ 48,700
Accounts receivable		2,600		Salary payable	900
Inventory		30,500		Interest payable	100
Supplies		600		Unearned service revenue	400
Prepaid rent		2,000		Total current liabilities	50,100
Total current assets			$ 40,500	Long-term liabilities:	
Plant assets:				Notes payable	20,000
Furniture	$18,000			Total liabilities	70,100
Less: Accumulated depreciation—furniture	300	17,700			
Building	48,000				
Less: Accumulated depreciation—building	200	47,800		**Owner's Equity**	
Total plant assets			65,500	Bright, capital	35,900
Total assets			$106,000	Total liabilities and owner's equity	$106,000

Learning Objectives

1. Define accounting vocabulary
2. Define the users of financial information
3. Describe the accounting profession and the organizations that govern it
4. Identify the different types of business organizations
5. Delineate the distinguishing characteristics and organization of a proprietorship
6. Apply accounting concepts and principles
7. Describe the accounting equation, and define assets, liabilities, and equity
8. Use the accounting equation to analyze transactions
9. Prepare financial statements
10. Use financial statements to evaluate business performance

Have you ever dreamed of running your own business? If so, where would you begin? How much money would you need? How would you measure its success or failure? Or maybe you're looking to become a manager in an organization. How would you gather the information you need to make strategic decisions? Do you have dreams of retiring early? If so, how do you pick companies to invest in? How can you make smart investment decisions throughout your life? You don't have to be an accountant to make good decisions, but understanding accounting can help you answer these questions and many more.

In this chapter, we'll start our exploration into accounting by looking at two businesses: Smart Touch Learning and Greg's Tunes. We'll see how the owners of these two businesses—Sheena Bright of Smart Touch and Greg Moore of Greg's Tunes—started successful companies by treating people fairly, having realistic expectations, and capitalizing on their general business and accounting savvy. We'll also see how understanding financial statements—like the balance sheet shown on the previous page—is one of the first steps toward business success.

Accounting Vocabulary: The Language of Business

1 Define accounting vocabulary

You've heard the term *accounting*, but what exactly is it? **Accounting** is the information system that measures business activity, processes the data into reports, and communicates the results to decision makers. **Accounting is "the language of business."** The better you understand the language of business, the better you can manage your own business. For example, how will you decide whether to borrow money to start up a business? You need to consider your income and whether you will be able to pay back that loan. Understanding what income is and how it's calculated is an accounting concept.

A key product of accounting is a set of reports called financial statements. **Financial statements** report on a business in monetary terms. Is Smart Touch making a profit? Should Greg's Tunes expand? If Greg's Tunes expands, how will it get the funds needed to expand? Where is Smart Touch's cash coming from? Financial statements help managers and owners answer questions like these and many more. We'll discuss financial statements in detail later in the chapter. For now, let's turn our attention to the users of accounting information.

Key Takeaway

Accounting is the language of business. Financial statements report a company's activities in monetary terms.

Decision Makers: The Users of Accounting Information

2 Define the users of financial information

We can divide accounting into two fields—financial accounting and managerial accounting.

Financial accounting provides information for external decision makers, such as outside investors and lenders. **Financial accounting provides data for outsiders.**

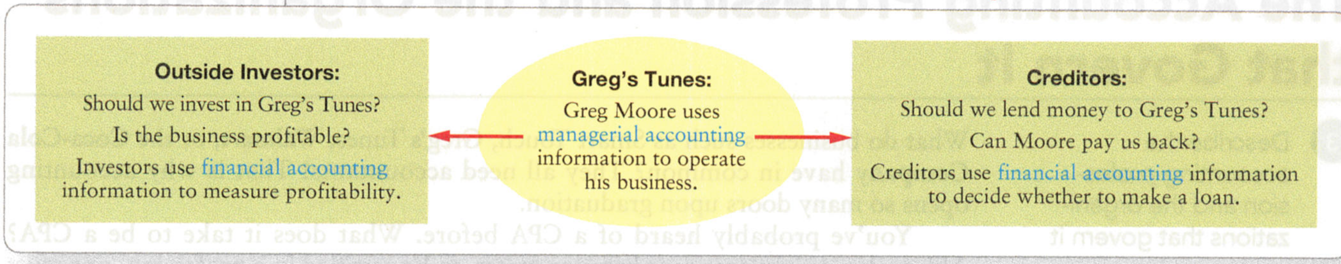
Managerial accounting focuses on information for internal decision makers, such as the company's managers. **Managerial accounting provides data for insiders.**

Exhibit 1-1 illustrates the difference between financial accounting and managerial accounting. Regardless of whether they are external or internal to the company, all decision makers need information to make the best choices. The bigger the decision, the more information decision makers need. Let's look at some ways in which various people use accounting information to make important decisions.

Individuals

How much cash do you have? How much do you need to save each month to retire at a certain age or pay for your children's college education? Accounting can help you answer questions like these. By using accounting information, you can manage your money, evaluate a new job, and better decide whether you can afford to buy a new computer. Businesses need accounting information to make similar decisions.

EXHIBIT 1-1 | Financial Accounting and Managerial Accounting



Businesses

Business owners use accounting information to set goals, to measure progress toward those goals, and to make adjustments when needed. The financial statements give owners the information they need to help make those decisions. For example, say Sheena Bright of Smart Touch wants to know whether her business is profitable enough to purchase another computer. Financial statements will help her make that decision.

Investors

Outside investors who have some ownership interest often provide the money to get a business going. For example, Smart Touch may need to raise cash for an expansion. Suppose you're considering investing in Smart Touch. How would you decide whether it is a good investment? In making this decision, you might try to predict the amount of income you would earn on the investment. Also, after making an investment, investors can use a company's financial statements to analyze how their investment is performing.

Every person has the opportunity to invest in their retirement through a company-sponsored retirement plan or IRA contributions. Which investments should you pick? Understanding a company's financial statements will help you decide. (Note that you can view the financial statements of large companies that report to the SEC by logging on to finance.yahoo.com, google.com/finance, or the Security and Exchange Commission's EDGAR database.)

Creditors

Any person or business lending money is a **creditor**. For example, suppose Smart Touch needs $200,000 to buy an office building. Before lending money to Smart Touch, a bank will evaluate the company's ability to make the loan payments by reviewing its financial statements. The same process will apply to you if you need to borrow money for a new car or a house. The bank will review accounting data to determine your ability to make the loan payments. What does your financial position tell the bank about your ability to pay the loan? Are you a good risk for the bank?

Taxing Authorities

Local, state, and federal governments levy taxes. Income tax is figured using accounting information. Good accounting records can help individuals and businesses take advantage of lawful deductions. Without good records, the IRS can disallow tax deductions, resulting in a higher tax bill plus interest and penalties.

Key Takeaway

Different users—including individuals, business owners, managers, investors, creditors, and tax authorities—review a company's financial statements for different reasons. Each user's goal will determine which pieces of the financial statements he or she will find most useful.

The Accounting Profession and the Organizations that Govern It

3 Describe the accounting profession and the organizations that govern it

What do businesses such as Smart Touch, Greg's Tunes, **Walmart**, or the **Coca-Cola Company** have in common? They all need accountants! That is why accounting opens so many doors upon graduation.

You've probably heard of a CPA before. What does it take to be a CPA? Although requirements vary between states, to be certified in a profession, one must meet the educational and/or experience requirements AND pass a qualifying exam. **Certified public accountants**, or CPAs, are licensed professional accountants who serve the general public. **Certified management accountants**, or CMAs, are certified professionals who work for a single company.

How much do accountants make? The average starting salary for a 2009 college graduate with a bachelor's degree in accounting was $48,334.[1] A graduate with a master's degree earns about 10% more to start, and CPAs earn another 10%.

Many accounting firms are organized as partnerships, and the partners are the owners. It usually takes 10 to 15 years to rise to the rank of partner. The partners of large accounting firms, such as **Ernst & Young**, earn from $150,000 to $500,000 per year. In private accounting, where accountants work for a single company, such as **Walmart**, the top position is called the chief financial officer (CFO), and a CFO earns about as much as a partner in an accounting firm.

Accountants get to the top of organizations as often as anyone else. Why? Because accountants must deal with every aspect of the company's business in order to record all of its activities. Accountants often have the broadest view of what is going on in the company.

As you move through this book, you will learn to account for everything that affects a business—all the revenue, all the expenses, all the cash, all the inventory, all the debts, and all the owner's accounts. Accounting requires you to consider everything, and that is why it is so valuable to an organization. Ultimately, accounting affects everyone, which is why it is important to you.

All professions have regulations. Let's look at the organizations that govern the accounting profession.

Governing Organizations

In the United States, the **Financial Accounting Standards Board (FASB)**, a privately funded organization, formulates accounting standards. The FASB works with governmental regulatory agencies like the Securities and Exchange Commission (SEC). The SEC is the U.S. governmental agency that oversees U.S. financial markets. It also oversees those organizations that set standards (like the FASB). The FASB also works with congressionally created groups like the Public Companies Accounting Oversight Board (PCAOB) and private groups like the American Institute of Certified Public Accountants (AICPA) and the Institute of Management Accountants (IMA).

The guidelines for public information are called **generally accepted accounting principles (GAAP)**. **GAAP is the main U.S. accounting rule book.** Some of these guidelines are described later in this chapter. Currently, the SEC has indicated that U.S. GAAP will move to converge with **international financial reporting standards (IFRS)** published by the **International Accounting Standards Board (IASB)** as early as 2012 for some companies. Whereas U.S. GAAP is more specific in its regulation, IFRS is

[1] http://www.employmentwebsites.org/salary-offers-college-class-2009-are-flat

less specific and based more on general principles, leaving more room for professional judgment. IFRS is the international accounting rule book.

Ethics in Accounting and Business

Ethical considerations affect accounting. Investors and creditors need relevant and reliable information about a company such as **Amazon.com** or **Walmart**. Companies want to be profitable and financially strong to attract investors, so there is a conflict of interest here. To provide reliable information, the SEC requires companies to have their financial statements audited by independent accountants. An **audit** is an examination of a company's financial records. The independent accountants then issue an opinion that states whether or not the financial statements give a fair picture of the company's financial situation.

The vast majority of accountants do their jobs professionally and ethically, but we never hear about them. Unfortunately, only those who cheat make the headlines. In recent years we have seen many accounting scandals.

In response to the **Enron** and **WorldCom** reporting scandals, the U.S. government took swift action. It passed the Sarbanes-Oxley Act, which made it a criminal offense to falsify financial statements. It also created a new watchdog agency, the PCAOB, to monitor the work of independent accountants who audit public companies. More recent scandals, such as the Bernie Madoff scandal, have further undermined the public's faith in financial reporting. This may result in more legislation for future reporting.

Standards of Professional Conduct

The AICPA's Code of Professional Conduct for Accountants provides guidance to CPAs in their work. Ethical standards are designed to produce relevant and reliable information for decision making. The preamble to the Code states the following:

> "[A] certified public accountant assumes an obligation of self-discipline above and beyond the requirements of laws and regulations ... [and] an unswerving commitment to honorable behavior... ."

The opening paragraph of the Standards of Ethical Conduct of the Institute of Management Accountants (IMA) states the following:

> "Management accountants have an obligation to the organizations they serve, their profession, the public, and themselves to maintain the highest standards of ethical conduct."

Most companies also set standards of ethical conduct for employees. For example, Greg's Tunes must comply with copyright laws in order to serve customers ethically. **Microsoft** has a highly developed set of business conduct guidelines. For example, **Microsoft** states that "it is not enough to intend to do things right, we must also do them in the right way."[2] A business's or an individual's reputation is often hard earned and can easily be lost. As one chief executive has stated, "Ethical practice is simply good business." Truth is always better than dishonesty—in accounting, in business, and in life.

Key Takeaway

Most U.S. businesses follow generally accepted accounting principles (GAAP). If the company is publicly traded, then it must also follow SEC guidelines. If the company operates internationally, then international financial reporting standards (IFRS) will apply. The goal is that, eventually, all public U.S. companies will report using IFRS rules.

Types of Business Organizations

4 Identify the different types of business organizations

A business can be organized as one of the following:

- Proprietorship
- Partnership

[2]Excerpt from http://www.microsoft.com/about/legal/en/us/Compliance/Buscond/Default.aspx

- Corporation
- Limited-liability partnership (LLP) and limited-liability company (LLC)
- Not-for-profit

Let's look at the differences among the five types of business organizations.

Proprietorships

A **proprietorship** has a single owner, called the proprietor, who often manages the business. Proprietorships tend to be small retail stores or professional businesses, such as attorneys and accountants. From an accounting perspective, every proprietorship is distinct from its owner: The accounting records of the proprietorship do *not* include the proprietor's personal records. However, from a legal perspective, the business *is* the proprietor. **A proprietorship has one owner called a proprietor.** Smart Touch Learning is a proprietorship.

Partnerships

A **partnership** joins two or more individuals as co-owners. Each owner is a partner and can commit the partnership in a binding contract. This is called **mutual agency.** Mutual agency means that one partner can make all partners mutually liable. Many retail stores and professional organizations of physicians, attorneys, and accountants are partnerships. Most partnerships are small or medium-sized, but some are gigantic, with thousands of partners. For accounting purposes, the partnership is a separate organization, distinct from the partners. **A partnership has two or more owners called partners.**

Corporations

A **corporation** is a business owned by **stockholders,** or **shareholders.** These are the people who own shares of stock in the business. **Stock** is a certificate representing ownership interest in a corporation. A business becomes a corporation when the state grants a **charter** to the company, and the state approves its articles of incorporation and the first stock share is issued. The **articles of incorporation** are the rules approved by the state that govern the management of the corporation. Unlike a proprietorship and a partnership, a corporation is a legal entity distinct from its owners. This legal distinction between corporations and traditional proprietorships and partnerships can be very important for the following reason: If a proprietorship or a partnership cannot pay its debts, lenders can take the owners' personal assets to satisfy the obligations. But if a corporation goes bankrupt, lenders *cannot* take the personal assets of the stockholders. The largest businesses in the United States and in other countries are corporations. The Coca-Cola Company, for example, has billions of shares of stock owned by many stockholders. **A corporation has one or more owners called shareholders.**

Limited-Liability Partnerships (LLPs) and Limited-Liability Companies (LLCs)

In a **limited-liability partnership,** each member/partner is liable (obligated) only for his or her own actions and those under his or her control. Similarly, a business can be organized as a **limited-liability company.** In an LLC, the business—and not the members of the LLC—is liable for the company's debts. This arrangement prevents an unethical partner from creating a large liability for the other partners, much like the protection a corporation has. Today most proprietorships and partnerships are organized as LLCs and LLPs. **An LLC has one or more owners called members.**

Not-for-Profits

A **not-for-profit** is an organization that has been approved by the Internal Revenue Service to operate for a religious, charitable, or educational purpose. A board, usually composed of volunteers, makes the decisions for the not-for-profit organization.

Board members have **fiduciary responsibility**, which is an ethical and legal obligation to perform their duties in a trustworthy manner. Their goal is to raise cash to fund their operations. Examples of not-for-profit organizations are the **United Way**, churches, and schools. A not-for-profit has no owners. Exhibit 1-2 summarizes the differences among the five types of business organization.

EXHIBIT 1-2 | Comparison of the Five Forms of Business Organization

	Proprietorship	Partnership	Corporation	LLP/LLC	Not-for-Profit
1. Owner(s)	Proprietor—only one owner	Partners—two or more owners	Stockholders—generally many owners	Members	None
2. Life of the organization	Limited by the owner's choice, or death	Limited by the owners' choice, or death	Indefinite	Indefinite	Indefinite
3. Personal liability of the owner(s) for the business's debts	Proprietor is personally liable	Partners are personally liable*	Stockholders are not personally liable	Members are not personally liable	Fiduciary liability of board members

*unless it is a limited-liability partnership (LLP)

Stop & Think...

How does a company pick the best type of organization? Deciding on the type of business organization that best meets a company's needs and objectives should be a well-thought-out decision. Small businesses should consult a CPA to consider the tax implications and an attorney to discuss the legal implications of the form of business.

Key Takeaway

There are five main forms of business organizations: proprietorships, partnerships, corporations, LLPs/LLCs, and not-for-profits. Each is unique in its formation, ownership, life, and liability exposure.

Distinguishing Characteristics and Organization of a Proprietorship

5 Delineate the distinguishing characteristics and organization of a proprietorship

There are several features that distinguish a proprietorship from other types of business organizations. Let's look at them now.

Separate Legal Entity

As we noted earlier, a *corporation* is a business entity formed under state law. The state grants a charter (articles of incorporation), which is the document that gives the state's permission to form a corporation. This is called **authorization** because the state "authorizes" or approves the establishment of the corporate entity.

A proprietorship is a business entity that is not formally "created" by registering with a state agency. It is formed when one individual decides to create a business. It is an entity that exists apart from its owner. However, the proprietorship has many of the rights that a person has. For example, a proprietorship may buy, own, and sell property; enter into contracts; sue; and be sued. Items that the business owns (its assets) and those items that the business has to pay later (its liabilities) belong to the business.

The ownership interest of a proprietorship is recognized in the capital account, which is part of owner's equity. This is listed in the company's books as "Name of owner, capital." So, for example, Sheena Bright is the owner of Smart Touch. Her capital account in the accounting records of Smart Touch would be named Bright, capital.

No Continuous Life or Transferability of Ownership

The life of a proprietorship business is limited by either the owner's choice or the owner's death, whichever comes first. Thus, there is no transferability of ownership in a proprietorship.

Unlimited Liability of Owner

A proprietor has unlimited liability for the business's debts. General partners in partnerships have the same liability; however, stockholders in corporations have limited liability. This unlimited liability makes owning a proprietorship unattractive due to the owner's real fear of losing his or her personal wealth if the proprietorship fails.

Unification of Ownership and Management

The owners of a proprietorship also manage the business. This unification between owners and management is beneficial to the proprietorship and its sole owner because their goals are the same.

Conversely, the separation that exists between stockholders (owners of the corporation) and management in a corporation may create problems. Corporate officers may decide to run the business for their own benefit rather than for the benefit of the company. Stockholders may find it difficult to lodge an effective protest against management because of the distance between them and the top managers.

Business Taxation

Proprietorships are not separate taxable entities. The income earned by the business flows directly to the sole owner. The owner pays tax on the business income on his or her personal tax return. Additionally, the owner must pay self-employment tax for both the employee and employer portions (discussed in Chapter 10).

Government Regulation

Government regulation is an advantage for the proprietorship. There are no stockholders to notify nor are there articles of incorporation to file. Decisions can easily be made by the sole owner/manager.

Organization of a Corporation

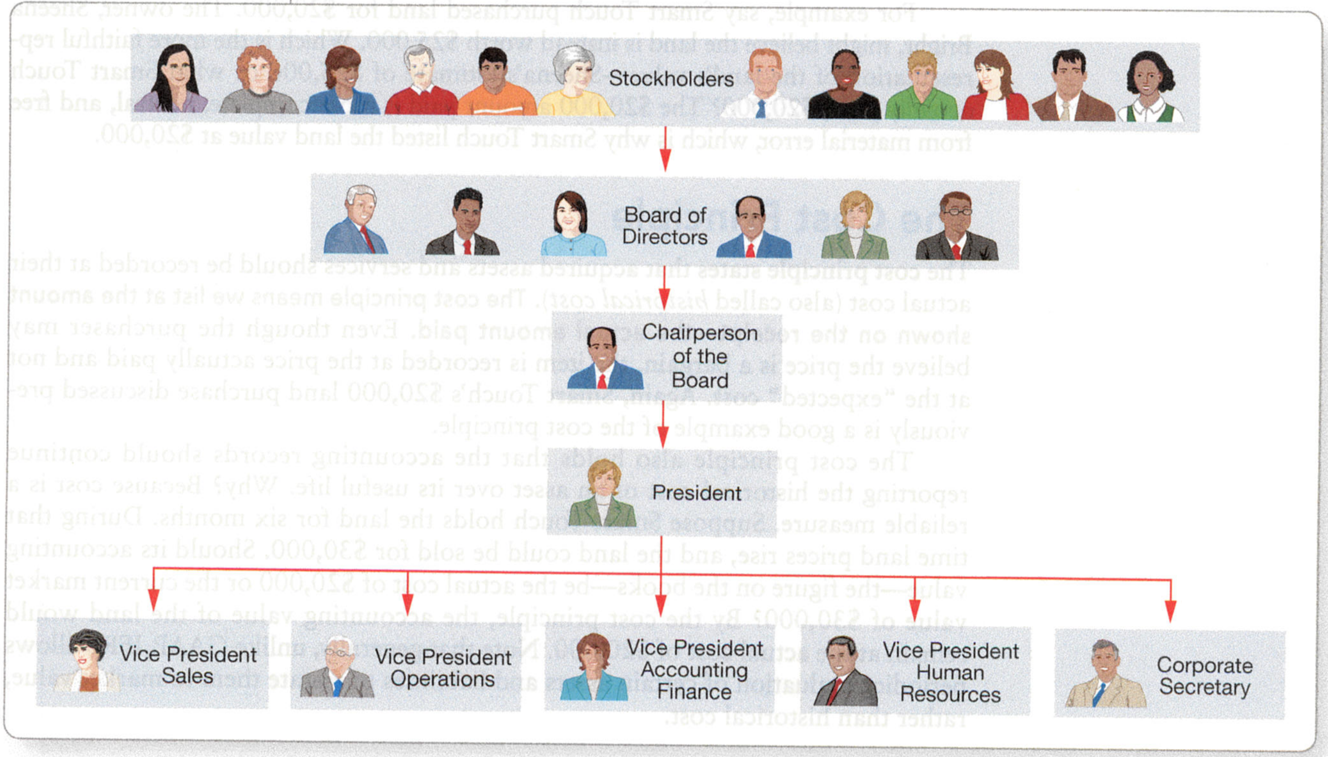
As noted earlier, creation of a corporation begins when its organizers, called the incorporators, obtain a charter from the state. The charter includes the authorization for the corporation to issue a certain number of shares of stock, which represent the ownership in the corporation. The incorporators pay fees, sign the charter, and file the required documents with the state. Once the first share of stock is issued, the corporation comes into existence. The incorporators agree to a set of bylaws, which act as the constitution for governing the corporation. **Bylaws are the rule book that guides the corporation.**

The ultimate control of the corporation rests with the stockholders, who normally receive one vote for each share of stock they own. The stockholders elect the members of the board of directors, which sets policy for the corporation and appoints the officers. The board elects a chairperson, who usually is the most powerful person in the corporation. The board also designates the president, who as chief operating officer manages day-to-day operations. Most corporations also have vice-presidents in charge of sales, operations, accounting and finance, and other key areas. Exhibit 1-3 shows the authority structure in a corporation. In the next section, we'll cover the concepts and principles behind financial statements.

Key Takeaway

Proprietorships are formed when one person creates a business. One person owns the proprietorship. Although the proprietorship is a separate entity, it has no continuous life and the owner has unlimited liability for the business's debts. Proprietorships have a more difficult time raising capital but have the advantage of reduced regulation and less taxes than the corporate form of business.

EXHIBIT 1-3 | **Structure of a Corporation**



Accounting Concepts and Principles

6 Apply accounting concepts and principles

As mentioned earlier in the chapter, the guidelines that govern accounting fall under GAAP, which stands for generally accepted accounting principles. GAAP rests on a conceptual framework. The primary objective of financial reporting is to provide information useful for making investment and lending decisions. To be useful, information must be relevant, reliable, and comparable. These basic accounting concepts and principles are part of the foundation for the financial reports that companies present.

The Entity Concept

The most basic concept in accounting is that of the **entity**. An accounting entity is an organization that stands apart as a separate economic unit. We draw boundaries around each entity to keep its affairs distinct from those of other entities. **An entity refers to one business, separate from its owners.**

Consider Smart Touch. Assume Sheena Bright started the business by investing capital of $30,000. Following the entity concept, Smart Touch accounted for the $30,000 separately from Sheena's personal assets, such as her clothing and car. To mix the $30,000 of business cash with her personal assets would make it difficult to measure the success or failure of Smart Touch. Thus, *the entity concept applies to any economic unit that needs to be evaluated separately*.

The Faithful Representation Principle

Accounting information is based on the fact that the data faithfully represents the measurement or description of that data. This guideline is the **faithful representation principle**. Faithfully represented data are complete, neutral, and free from material error. For example, a promissory note outlines the details of a bank loan. This note is a faithful representation (evidence) of the loan.

For example, say Smart Touch purchased land for $20,000. The owner, Sheena Bright, might believe the land is instead worth $25,000. Which is the more faithful representation of the land's value—Sheena's estimate of $25,000 or what Smart Touch actually paid, $20,000? The $20,000 amount paid is more complete, neutral, and free from material error, which is why Smart Touch listed the land value at $20,000.

The Cost Principle

The **cost principle** states that acquired assets and services should be recorded at their actual cost (also called *historical cost*). **The cost principle means we list at the amount shown on the receipt—the actual amount paid.** Even though the purchaser may believe the price is a bargain, the item is recorded at the price actually paid and not at the "expected" cost. Again, Smart Touch's $20,000 land purchase discussed previously is a good example of the cost principle.

The cost principle also holds that the accounting records should continue reporting the historical cost of an asset over its useful life. Why? Because cost is a reliable measure. Suppose Smart Touch holds the land for six months. During that time land prices rise, and the land could be sold for $30,000. Should its accounting value—the figure on the books—be the actual cost of $20,000 or the current market value of $30,000? By the cost principle, the accounting value of the land would remain at the actual cost of $20,000. Note that generally, unlike GAAP, IFRS allows periodic revaluation of certain assets and liabilities to restate them to market value, rather than historical cost.

The Going-Concern Concept

Another reason for measuring assets at historical cost is the **going-concern concept**. This concept assumes that the entity will remain in operation for the foreseeable future. Under the going-concern concept, accountants assume that the business will remain in operation long enough to use existing resources for their intended purpose. **The going-concern principle assumes the business won't close soon.**

To understand the going-concern concept better, consider the alternative—which is to go out of business. A store that is closing intends to cease future operations. In that case, the relevant measure is current market value. But going out of business is the exception rather than the rule, which is why we use historical cost.

The Stable Monetary Unit Concept

In the United States, we record transactions in dollars because the dollar is the medium of exchange. The value of a dollar changes over time, and a rise in the price level is called inflation. During periods of inflation, a dollar will purchase less. But accountants assume that the dollar's purchasing power is stable. This assumption is the basis of the **stable monetary unit concept**. **The stable monetary unit concept means stable currency buying power.**

Now that we've reviewed some of the basic concepts/assumptions underlying financial statements, we'll cover the accounting equation.

Key Takeaway

The accounting concepts are the underlying assumptions used when recording financial information for a business. Think of the concepts like rules of a game. You have to play by the rules.

The Accounting Equation

7 Describe the accounting equation, and define assets, liabilities, and equity

The basic tool of accounting is the **accounting equation**. It measures the resources of a business and the claims to those resources.

Assets and Liabilities

Assets are economic resources that are expected to benefit the business in the future. **Assets are something the business owns that has value.** Cash, merchandise inventory, furniture, and land are examples of assets.

Claims to those assets come from two sources. **Liabilities** are debts payable to outsiders who are known as creditors. **Liabilities are something the business owes.** For example, a creditor who has loaned money to Smart Touch has a claim to some of the business's assets until the business pays the debt. Many liabilities have the word *payable* in their titles. Examples include Accounts payable, Notes payable, and Salary payable.

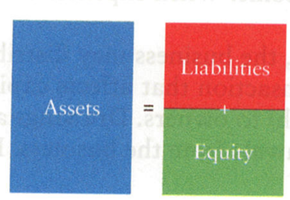
The owner's claims to the assets of the business are called **equity** (also called **owner's, stockholders'**, or **shareholders' equity**, depending on how the company is organized). **Equity equals what is owned (assets) minus what is owed (liabilities). It is the company's net worth.** These insider claims begin when an owner, such as Sheena Bright, invests assets in the business and receives capital.

The accounting equation shows how assets, liabilities, and owner's equity are related. Assets appear on the left side of the equation, and the liabilities and owner's equity appear on the right side. **The accounting equation is an equation—so the left side of the equation always equals the right side of the equation.**

Exhibit 1-4 diagrams how the two sides must always be equal (amounts are assumed for this illustration):

(Economic Resources)		(Claims to Economic Resources)
ASSETS	=	LIABILITIES + EQUITY
$5,000	=	$2,000 + $3,000

EXHIBIT 1-4 | The Accounting Equation



Equity

The equity of a sole proprietorship is called owner's equity. For a proprietorship, the accounting equation can be written as

$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNER'S EQUITY}$$
$$\text{ASSETS} = \text{LIABILITIES} + \text{CAPITAL}$$

- **Capital** is the net amount invested in the business by the owner. An owner can contribute cash or other net assets to the business and receive capital.
- Capital contains the amount earned by income-producing activities and kept (retained) for use in the business. Two types of events that affect capital are revenues and expenses. **Revenues** are increases in capital from delivering goods or services to customers. **Revenues are earnings.** For example, if Smart Touch provided e-learning services and earned $5,500 of revenue, the business's capital increased by $5,500.

There are relatively few types of revenue, including the following:

- **Sales revenue.** Greg's Tunes earns sales revenue by selling CDs to customers.
- **Service revenue.** Smart Touch earns service revenue by providing e-learning services.
- **Interest revenue.** Interest revenue is earned on bank deposits and on money lent out to others.
- **Dividend revenue.** Dividend revenue is earned on investments in the stock of other corporations.

Expenses are the decreases in capital that result from operations. **Expenses are incurred costs that you will have to pay for, either now or later.** For example, Smart Touch paid salaries of $1,200 to its employees and that is an expense that decreases capital. Expenses are the opposite of revenues.

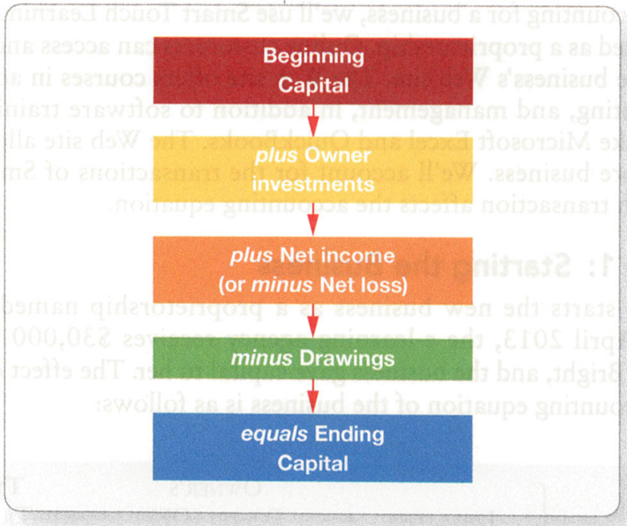
Unfortunately, businesses have lots of expenses. Some common expenses are as follows:

- Store (or office) rent expense
- Salary expense for employees
- Advertising expense
- Utilities expense for water, electricity, and gas
- Insurance expense
- Supplies expense for supplies used up
- Interest expense on loans payable
- Property tax expense

Businesses strive for net income. When revenues exceed expenses, the result of operations is a profit or **net income**. When expenses exceed revenues, the result is a **net loss**.

After earning net income, the business may distribute cash or other assets to the owner, a third type of transaction that affects capital. **Drawings** are distributions of capital (usually of cash) to owners. Drawings are not expenses. An owner may or may not make withdrawals from the business. Exhibit 1-5 shows the components of capital.

EXHIBIT 1-5 Components of Capital



The owners' equity of partnerships is similar. The main difference is there are separate capital accounts for each partner. For example, a partnership of Joan Pratt and Simon Nagle would have accounts for Pratt, capital and Nagle, capital. The owners' equity (or shareholders' or stockholders' equity) of a corporation is also different. Stockholders' equity has two components: Paid-in capital and Retained earnings. **Paid-in capital**, or **contributed capital**, is the amount invested in the corporation by its owners, the stockholders. The basic component of paid-in capital is stock, which the corporation issues to the stockholders as evidence of their ownership. **Common stock** represents the basic ownership of every corporation. **Retained earnings** of a corporation represent the net earnings retained by the corporation.

Stop & Think...

The accounting equation is important to a business, but it is also important to the individual. Consider your "personal" accounting equation. Are you content with your current net worth (equity) or do you want to increase it? Do you think your education will help you to increase your net worth?

Students enroll in education programs for many reasons. However, underneath all the reasons is a basic desire to increase net worth through knowledge, higher paying job skills, or a better understanding of business.

Key Takeaway

The accounting equation must always equal. That is, Assets (what you own) must equal Liabilities (what you owe) + Equity (net worth). In a proprietorship, equity is the owner's capital account.

Accounting for Business Transactions

8 Use the accounting equation to analyze transactions

Accounting is based on actual transactions, not opinions or desires. A **transaction** is any event that affects the financial position of the business *and* can be measured reliably. **Transactions affect what the company owns, owes, or its net worth.** Many events affect a company, including economic booms and recessions. Accountants, however, do not record the effects of those events. An accountant records only those events that have dollar amounts that can be measured reliably, such as the purchase of a building, a sale of merchandise, and the payment of rent.

What are some of your personal transactions? You may have bought a car. Your purchase was a transaction. If you are making payments on an auto loan, your payments are also transactions. You need to record all your business transactions—just as Smart Touch does—in order to manage your business affairs.

Transaction Analysis for Smart Touch Learning

To illustrate accounting for a business, we'll use Smart Touch Learning, an e-learning agency organized as a proprietorship. Online customers can access and pay for training through the business's Web site. The Web site offers courses in accounting, economics, marketing, and management, in addition to software training on specific applications, like Microsoft Excel and QuickBooks. The Web site allows the agency to transact more business. We'll account for the transactions of Smart Touch and show how each transaction affects the accounting equation.

Transaction 1: Starting the Business

Sheena Bright starts the new business as a proprietorship named Smart Touch Learning. In April 2013, the e-learning agency receives $30,000 cash from the owner, Sheena Bright, and the business gave capital to her. The effect of this transaction on the accounting equation of the business is as follows:

Assets		Liabilities +	Owner's Equity (OE)	Type of OE Transaction
Cash	=		Bright, capital	
(1) +30,000			+30,000	*Owner investment*

For each transaction, the amount on the left side of the equation must equal the amount on the right side. The first transaction increases both the assets (in this case, Cash) and the owner's equity (Bright, capital) of the business. To the right of the transaction, we write "Owner investment" to keep track of the source of the equity.

BE SURE TO START ON THE RIGHT TRACK—Keep in mind that we are doing the accounting for Smart Touch Learning, the business. We are *not* accounting for Sheena Bright, the person.

View all transactions, and do all the accounting, from the perspective of the business—not from the viewpoint of the owner. This is the entity concept we reviewed earlier in the chapter.

Transaction 2: Purchase of Land

The business purchases land for an office location, paying cash of $20,000. This transaction affects the accounting equation of Smart Touch as follows:

	Assets			Liabilities +	Owner's Equity
	Cash +	Land			Bright, capital
(1)	30,000		=		30,000
(2)	−20,000	+20,000			
Bal	10,000	20,000			30,000
	30,000				30,000

The cash purchase of land increases one asset, Land, and decreases another asset, Cash. After the transaction is completed, the business has cash of $10,000, land of $20,000, no liabilities, and owner's equity of $30,000. Note that the total balances (abbreviated Bal) on both sides of the equation must always be equal—in this case $30,000.

Transaction 3: Purchase of Office Supplies

The e-learning agency buys office supplies on account (credit), agreeing to pay $500 within 30 days. The company will use the supplies in the future, so they are an asset to the business. This transaction increases both the assets and the liabilities of the business, as follows:

	Assets					Liabilities	+	Owner's Equity
	Cash	+ Office supplies	+ Land			Accounts payable	+	Bright, capital
Bal	10,000		20,000	=				30,000
(3)		+500				+500		
Bal	10,000	500	20,000			500		30,000
		30,500					30,500	

Office supplies is an asset, not an expense, because the supplies aren't used up now, but will be in the future. The liability created by purchasing "on account" is an **Account payable**, which is a short-term liability that will be paid in the future. A payable is always a liability.

Transaction 4: Earning of Service Revenue

Smart Touch earns service revenue by providing training services for clients. The business earns $5,500 of revenue and collects this amount in cash. The effect on the accounting equation is an increase in Cash and an increase in Bright, capital as follows:

	Assets				Liabilities	+ Owner's Equity	Type of OE Transaction
	Cash	+ Office supplies	+ Land		Accounts payable +	Bright, capital	
Bal	10,000	500	20,000	=	500	30,000	
(4)	+5,500					+5,500	*Service revenue*
Bal	15,500	500	20,000		500	35,500	
		36,000				36,000	

A revenue transaction grows the business, as shown by the increases in assets and owner's equity (Bright, capital).

Transaction 5: Earning of Service Revenue on Account

Smart Touch performs a service for clients who do not pay immediately. The business receives the clients' promise to pay $3,000 within one month. This promise is an asset, an **Account receivable**, because the agency expects to collect the cash in the future. In accounting, we say that Smart Touch performed this service *on account*. It is in performing the service (doing the work), not collecting the cash, that the company *earns* the revenue. As in transaction 4, increasing earnings increases Bright, capital. Smart Touch records the earning of $3,000 of revenue on account, as follows:

	ASSETS					LIABILITIES + OWNER'S EQUITY		TYPE OF OE TRANSACTION
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+ Bright, capital	
Bal	15,500		500	20,000	=	500	35,500	
(5)		+3,000					+3,000	*Service revenue*
Bal	15,500	3,000	500	20,000		500	38,500	
	39,000					39,000		

Transaction 6: Payment of Expenses

During the month, the business pays $3,300 in cash expenses: rent expense on a computer, $600; office rent, $1,100; employee salary, $1,200; and utilities, $400. The effects on the accounting equation are as follows:

	ASSETS					LIABILITIES + OWNER'S EQUITY		TYPE OF OE TRANSACTION
	Cash	+ Accounts receivable	+ Office supplies	+ Land		Accounts payable	+ Bright, capital	
Bal	15,500	3,000	500	20,000		500	38,500	
(6)	−600						−600	*Rent expense, computer*
(6)	−1,100				=		−1,100	*Rent expense, office*
(6)	−1,200						−1,200	*Salary expense*
(6)	−400						−400	*Utilities expense*
Bal	12,200	3,000	500	20,000		500	35,200	
	35,700					35,700		

Expenses have the opposite effect of revenues. Expenses shrink the business, as shown by the decreased balances of assets and owner's equity (Bright, capital).

Each expense can be recorded separately. The expenses are listed as one transaction here for simplicity. We could record the cash payment in a single amount for the sum of the four expenses: $3,300 ($600 + $1,100 + $1,200 + $400). However the expenses are recorded, the accounting equation must balance. (Notice that each side totals to $35,700.)

Transaction 7: Payment on Account

The business pays $300 to the store from which it purchased supplies in transaction 3. In accounting, we say that the business pays $300 *on account*. The effect on the accounting equation is a decrease in Cash and a decrease in Accounts payable, as shown here:

	Assets					Liabilities + Owner's Equity	
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Bright, capital
Bal	12,200	3,000	500	20,000	=	500	35,200
(7)	−300					−300	
Bal	11,900	3,000	500	20,000		200	35,200
	35,400					35,400	

The payment of cash on account has no effect on the amount of office supplies (asset) Smart Touch has nor on the amount of office supplies it uses (expense). Smart Touch was paying off a liability (accounts payable decreased $300), with cash (Cash decreased $300).

Transaction 8: Personal Transaction

Sheena Bright buys groceries at a cost of $200, paying cash from personal funds. This event is *not* a transaction of Smart Touch. It has no effect on the e-learning agency and, therefore, is not recorded by the business. It is a transaction of the Sheena Bright *personal* entity, not the e-learning agency. This transaction illustrates the *entity concept*.

Transaction 9: Collection on Account

In transaction 5, the business performed services for a client on account. The business now collects $1,000 from the client. We say that Smart Touch collects the cash *on account*. The business will record an increase in the asset Cash. Should it also record an increase in service revenue? No, because the business already recorded the revenue when it earned the revenue in transaction 5. The phrase "collect cash on account" means to record an increase in Cash and a decrease in Accounts receivable. Accounts receivable is decreased because the $1,000 that the business was to collect at some point in the future is being collected today. The effect on the accounting equation is as follows:

	Assets					Liabilities + Owner's Equity	
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Bright, capital
Bal	11,900	3,000	500	20,000	=	200	35,200
(9)	+1,000	−1,000					
Bal	12,900	2,000	500	20,000		200	35,200
	35,400					35,400	

Total assets are unchanged from the preceding total. Why? Because Smart Touch exchanged one asset (Cash) for another (Accounts receivable).

Transaction 10: Sale of Land

The business sells some land owned by the e-learning agency. The sale price of $9,000 is equal to the cost of the land, so Smart Touch didn't gain or lose anything extra from the land sale. The business receives $9,000 cash, and the effect on the accounting equation follows:

	ASSETS					LIABILITIES +	OWNER'S EQUITY
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Bright, capital
Bal	12,900	2,000	500	20,000	=	200	35,200
(10)	+9,000			−9,000			
Bal	21,900	2,000	500	11,000		200	35,200
	35,400					35,400	

Transaction 11: Owner Drawing of Cash

Sheena Bright withdraws $2,000 cash from the business. The effect on the accounting equation is:

	ASSETS					LIABILITIES +	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Bright, capital	
Bal	21,900	2,000	500	11,000	=	200	35,200	
(11)	−2,000						−2,000	*Owner withdrawal*
Bal	19,900	2,000	500	11,000		200	33,200	
	33,400					33,400		

Key Takeaway

The accounting equation is Assets = Liabilities + Equity. Every business transaction affects various parts of the equation, but after each transaction is recorded, the equation must ALWAYS balance (equal).

The owner withdrawal decreases the business's Cash and owner's equity (Bright, capital). *Drawings do not represent an expense because they are not related to the earning of revenue. Therefore, drawings do not affect the business's net income or net loss.* The double underlines below each column indicate a final total after the last transaction.

Preparing the Financial Statements—The User Perspective of Accounting

9 Prepare financial statements

We have now recorded Smart Touch's transactions, and they are summarized in Exhibit 1-6. Notice how total assets equals total liabilities plus owner's equity.

But a basic question remains: How will people actually use this information? The mass of data in Exhibit 1-6 will not tell a lender whether Smart Touch can pay off a loan. The data in the exhibit do not tell whether the business is profitable.

To address these important questions, we need financial statements. As noted earlier, *financial statements* are business documents that report on a business in

EXHIBIT 1-6 | **Analysis of Transactions, Smart Touch Learning**

PANEL A—Details of Transactions

1. The e-learning agency received $30,000 cash and gave capital to Sheena Bright.
2. Paid $20,000 cash for land.
3. Bought $500 of office supplies on account.
4. Received $5,500 cash from clients for service revenue earned.
5. Performed services for clients on account, $3,000.
6. Paid cash expenses: computer rent, $600; office rent, $1,100; employee salary, $1,200; utilities, $400.
7. Paid $300 on the account payable created in transaction 3.
8. Bright buys $200 of groceries. This is *not* a transaction of the business.
9. Collected $1,000 on the account receivable created in transaction 5.
10. Sold land for cash at its cost of $9,000.
11. Owner withdrew cash of $2,000.

PANEL B—Analysis of Transactions

	Assets					Liabilities +	Owner's Equity (OE)	Type of OE Transaction
	Cash +	Accounts receivable +	Office supplies +	Land	=	Accounts payable +	Bright, capital	
1.	+ 30,000						+ 30,000	*Owner investment*
Bal	30,000	0	0	0		0	30,000	
2.	− 20,000			+ 20,000				
Bal	10,000	0	0	20,000		0	30,000	
3.			+ 500			+ 500		
Bal	10,000	0	500	20,000		500	30,000	
4.	+ 5,500						+ 5,500	*Service revenue*
Bal	15,500	0	500	20,000		500	35,500	
5.		+ 3,000					+ 3,000	*Service revenue*
Bal	15,500	3,000	500	20,000		500	38,500	
6.	− 600						− 600	*Rent expense, computer*
6.	− 1,100						− 1,100	*Rent expense, office*
6.	− 1,200						− 1,200	*Salary expense*
6.	− 400						− 400	*Utilities expense*
Bal	12,200	3,000	500	20,000		500	35,200	
7.	− 300					− 300		
Bal	11,900	3,000	500	20,000		200	35,200	
8.	Not a transaction of the business							
9.	+ 1,000	− 1,000						
Bal	12,900	2,000	500	20,000		200	35,200	
10.	+ 9,000			− 9,000				
Bal	21,900	2,000	500	11,000		200	35,200	
11.	− 2,000						− 2,000	*Owner withdrawal*
Bal	19,900	2,000	500	11,000		200	33,200	
	33,400					33,400		

Connect To: Accounting Information Systems (AIS)

The accounting information system is the system that records the transactions for a company. It can be manual or computerized. Most businesses today use some sort of computerized system, which simplifies repetitive transactions. However, the system must be able to not only record transactions properly, but also comply with regulatory agencies, such as the SEC, GAAP, IFRS, and/or the PCAOB. Another way to say this is the AIS must be able to meet a variety of users' different reporting needs so those users can get the information they require.

monetary terms. People use financial statements to make business decisions. Consider the following examples:

- Sheena Bright wants to know whether the business is profitable. Is the business earning a net income, or is it experiencing a net loss? The **income statement** answers this question by reporting the net income or net loss of the business.
- The banker asks what the business did with any profits earned. Did Bright withdraw the earnings or did she keep the earnings in the training agency? The **statement of owner's equity** answers this question. Suppose the business needs $200,000 to buy an office building. The banker will want to know how much in assets the e-learning company has and how much it already owes. The **balance sheet** answers this question by reporting the business's assets and liabilities.
- The banker wants to know if the agency generates enough cash to pay its bills. The **statement of cash flows** answers this question by reporting cash receipts and cash payments and whether cash increased or decreased.
- Outside investors also use financial statements. Smart Touch may need to raise cash for an expansion. Suppose you are considering investing in the training agency. In making this decision, you would ask the same questions that Sheena Bright and the banker have been asking.

In summary, the main users of financial statements are

- business owners and managers,
- lenders, and
- outside investors.

Others also use the financial statements, but the three user groups listed above are paramount, and we will be referring to them throughout this book. Now let's examine the financial statements in detail.

The Financial Statements

After analyzing transactions, we want to see the overall results. The financial statements summarize the transaction data into a form that is useful for decision making. As we discussed the financial statements are the

- income statement,
- statement of owner's equity,
- balance sheet, and
- statement of cash flows.

Headings

Each financial statement (and every other financial document you'll probably see or use) has a heading that provides three pieces of data:

- Name of the business (such as Smart Touch Learning)
- Name of the financial statement (income statement, balance sheet, or other financial statement)
- Date or time period covered by the statement (April 30, 2013, for the balance sheet; month ended April 30, 2013, for the other statements)

Financial statements that show activity, like an income statement that covers a year that ended in December 2013, are dated "Year Ended December 31, 2013." A monthly income statement (or statement of owner's equity) for September 2013 shows "Month Ended September 30, 2013." A quarterly income statement (or statement of owner's equity) for the three months ending June 30, 2013, shows "Quarter Ended June 30, 2013." **The dateline describes the period covered by the statement.** Let's look at each of these financial statements in a bit more detail.

Income Statement

The income statement (also called the **statement of earnings** or **statement of operations**) presents a summary of a business entity's revenues and expenses for a period of time, such as a month, quarter, or year. The income statement is like a video—a moving picture of operations during the period. It displays one of the most important pieces of information about a business: Did the business make a profit? The income statement tells us whether the business enjoyed net income or suffered a net loss. Remember,

- **net income** means total revenues are greater than total expenses.
- **net loss** means total expenses are greater than total revenues.

Net income is good news, net loss is bad news. What was the result of Smart Touch's operations during April? Good news—the business earned net income of $5,200 (see the first part of Exhibit 1-7 on the next page).

Statement of Owner's Equity

The statement of owner's equity (shown in the first overlay of Exhibit 1-7) shows the changes in capital for a business entity during a time period, such as a month, quarter, or year.

Capital increases when the business has

- owner contributions of capital, or
- a net income (revenues exceed expenses).

Capital decreases when the business has

- a net loss (expenses exceed revenues), or
- owner withdrawals of cash or other assets.

What changes occurred in Smart Touch's capital during April? Capital increased by the $30,000 of capital contributed by Sheena Bright and by the amount of net income of $5,200. Capital decreased $2,000 for the drawing made by Sheena Bright (see Exhibit 1-7).

Balance Sheet

The balance sheet lists a business entity's assets, liabilities, and owner's equity as of a specific date, usually the end of a month, quarter, or year. The balance sheet is like a snapshot of the entity. It is also called the **statement of financial position** (see the second overlay showing the middle of Exhibit 1-7.) **The balance sheet mirrors the accounting equation.**

Statement of Cash Flows

The statement of cash flows reports the cash coming in (positive amounts) and the cash going out (negative amounts) during a period. Business activities result in a net cash inflow or a net cash outflow. The statement of cash flows reports the net increase or decrease in cash during the period and the ending cash balance. (See the final overlay of Exhibit 1-7.)

In the first part of this book, we focus on the

- income statement,
- statement of owner's equity, and
- balance sheet.

In Chapter 14 we cover the statement of cash flows in detail.

Key Takeaway

Financial statements are prepared from the ending balances of each account. Each financial statement shows a different view of the company's overall results.

EXHIBIT 1-7 **Financial Statements of Smart Touch Learning**

SMART TOUCH LEARNING
Income Statement
Month Ended April 30, 2013

Revenue:		
Service revenue		$8,500
Expenses:		
Salary expense	$1,200	
Rent expense, office	1,100	
Rent expense, computer	600	
Utilities expense	400	
Total expenses		3,300
Net income		$5,200

Using Financial Statements to Evaluate Business Performance

10 Use financial statements to evaluate business performance

Exhibit 1-7 illustrates all four financial statements in the order that we prepare them. The data come from the transaction analysis in Exhibit 1-6 that covers the month of April 2013. Study the exhibit carefully. Then, observe the following in Exhibit 1-7:

1. The *income statement* for the month ended April 30, 2013,
   a. reports April's revenues and expenses.
   b. lists expenses in order of largest to smallest expense.
   c. calculates and lists total expenses.
   d. reports *net income* of the period if total revenues exceed total expenses. If total expenses exceed total revenues, a *net loss* is reported instead.
2. The *statement of owner's equity* for the month ended April 30, 2013,
   a. opens with the capital balance at the beginning of the period (zero for a new entity).
   b. adds *owner contributions* made during the month.
   c. adds *net income* directly from the income statement (see arrow 1 in Exhibit 1-7).
   d. subtracts *drawings* (and net loss, if applicable). Parentheses indicate a subtraction.
   e. ends with the capital balance at the end of the period.
3. The *balance sheet* at April 30, 2013,
   a. reports all *assets*, all *liabilities*, and *owner's equity* at the end of the period.
   b. lists assets in the order of their liquidity (closeness to cash) with cash coming first because it is the most liquid asset.
   c. reports liabilities similarly. That is, the liability that must be paid first is listed first, usually Accounts payable.
   d. reports that total assets equal total liabilities plus total equity (the accounting equation).
   e. reports the ending capital balance, taken directly from the statement of owner's equity (see arrow 2).
4. The *statement of cash flows* for the month ended April 30, 2013,
   a. reports cash flows from three types of business activities (*operating*, *investing*, and *financing activities*) during the month. Each category of cash-flow activities includes both cash receipts (positive amounts), and cash payments (negative amounts denoted by parentheses).
   b. reports a net increase (or decrease) in cash during the month and ends with the cash balance at April 30, 2013. This is the amount of cash to report on the balance sheet (see arrow 3).

Each of the statements identified in Exhibit 1-7 provides different information about the company to the users of the financial statements.

- The income statement provides information about profitability for a particular period for the company. Recall that expenses are listed in this statement from largest to smallest. This ordering shows users which expenses are consuming the largest part of the revenues.

- The statement of owner's equity informs users about how much of the earnings were kept and reinvested in the company. Recall from Exhibit 1-7 that three main items appear in this statement that explain the change in the capital balance:

1. Owner contributions
2. Net income or net loss
3. Drawings by the owner

If the owner drawings were larger than income for the period, this could signal concern to financial statement users.

The balance sheet in Exhibit 1-7 provides valuable information to financial statement users about economic resources the company owns (assets) as well as debts the company owes (liabilities). Thus, the balance sheet presents the overall financial position of the company on a specific date. This allows decision makers to determine their opinion about the financial status of the company.

The cash flow statement is covered in detail in a later chapter in the textbook. Briefly, its purpose and value to users is to explain why the net income number on the income statement does not equal the change in the cash balance for the period.

As we conclude this chapter, we return to our opening question: Have you ever thought of having your own business? The Decision Guidelines feature on the next page shows how to make some of the decisions that you will face if you start a business. Decision Guidelines appear in each chapter.

Key Takeaway

Financial statements are prepared from the transaction analyses (summary of events) reported in each account (Exhibit 1-6) in the order shown in Exhibit 1-7. No one financial statement shows everything about a company. It is the financial statements AND the relationships the statements show that give users the overall picture for a specific company.

Decision Guidelines 1-1

MAJOR BUSINESS DECISIONS

Suppose you open a business to take photos at parties at your school. You hire a professional photographer and line up suppliers for party favors and photo albums. Here are some factors you must consider if you expect to be profitable.

Decision	Guidelines
• How to organize the business?	If a single owner—a *proprietorship*. If two or more owners, but not incorporated— a *partnership* or *limited liability company*. If the business issues stock to stockholders—a *corporation*. If the motives are religious, charitable, or educational—a *not-for-profit*.
• What to account for?	Account for the business, a separate entity apart from its owner (*entity concept*). Account for transactions and events that affect the business's accounting equation and can be measured reliably.
• How much to record for assets and liabilities?	U.S. GAAP—Actual historical amount (*cost principle*). IFRS—Market value.
• How to analyze a transaction?	The accounting equation: (own) = (owe) + (net worth) Assets = Liabilities + Owner's Equity
• How to measure profits and losses?	Income statement: Revenues − Expenses = Net Income (or Net Loss)
• Did owner's equity increase or decrease?	Statement of owner's equity: Beginning capital + Owner investments + Net income (or − Net loss) − Drawings = Ending capital
• Where does the business stand financially?	Balance sheet (accounting equation): Assets = Liabilities + Owner's Equity

Summary Problem 1-1

Ron Smith opens an apartment-locator business near a college campus. The company will be named Campus Apartment Locators. During the first month of operations, July 2013, the business completes the following transactions:

a. Smith invests $35,000. The business receives $35,000 cash and gives capital to Smith.
b. Purchases $350 of office supplies on account.
c. Pays cash of $30,000 to acquire a lot next to the campus. Smith intends to use the land as a future building site for the business office.
d. Locates apartments for clients and receives cash of $1,900.
e. Pays $100 on the account payable he created in transaction b.
f. Pays $2,000 of personal funds for a vacation.
g. Pays cash expenses for office rent, $400, and utilities, $100.
h. Returns office supplies of $150 from transaction b.
i. Smith withdrew cash of $1,200.

Requirements

1. Analyze the preceding transactions in terms of their effects on the accounting equation of Campus Apartment Locators. Use Exhibit 1-6 as a guide, but show balances only after the last transaction.
2. Prepare the income statement, statement of owner's equity, and balance sheet of the business after recording the transactions. Use Exhibit 1-7 as a guide.

Solution

Requirement 1

Analysis of transactions

	Assets					=	Liabilities + Owner's Equity			Type of OE Transaction
	Cash	+	Office supplies	+	Land		Accounts payable	+	Smith, capital	
(a)	+35,000								+35,000	*Owner investment*
(b)			+350				+350			
(c)	−30,000				+30,000					
(d)	+1,900								+1,900	*Service revenue*
(e)	−100						−100			
(f)	Not a transaction of the business									
(g)	−400								−400	*Rent expense*
	−100								−100	*Utilities expense*
(h)			−150				−150			
(i)	−1,200								−1,200	*Owner withdrawal*
Bal	5,100		200		30,000		100		35,200	
	35,300						35,300			

Requirement 2

Financial Statements of Campus Apartment Locators.

CAMPUS APARTMENT LOCATORS
Income Statement
Month Ended July 31, 2013

Revenue:		
Service revenue		$1,900
Expenses:		
Rent expense	$400	
Utilities expense	100	
Total expenses		500
Net income		$1,400

CAMPUS APARTMENT LOCATORS
Statement of Owner's Equity
Month Ended July 31, 2013

Smith, capital, July 1, 2013	$ 0
Owner investment	35,000
Net income for the month	1,400
	36,400
Drawing	(1,200)
Smith, capital, July 31, 2013	$35,200

CAMPUS APARTMENT LOCATORS
Balance Sheet
July 31, 2013

Assets		Liabilities	
Cash	$ 5,100	Accounts payable	$ 100
Office supplies	200		
Land	30,000		
		Owner's Equity	
		Smith, capital	35,200
Total assets	$35,300	Total liabilities and owner's equity	$35,300

Chapter 1: Demo Doc

Transaction Analysis Using Accounting Equation/Financial Statement Preparation

To make sure you understand this material, work through the following demonstration "demo doc" with detailed comments to help you see the concept within the framework of a worked-through problem.

7 8 9

On March 1, 2014, David Richardson started a painting business near a historical housing district. David was the sole proprietor of the company, which he named DR Painting. During March 2014, DR Painting engaged in the following transactions:

a. DR Painting received cash of $40,000 from David Richardson and gave capital to Richardson.
b. The business paid $20,000 cash to acquire a truck.
c. The business purchased supplies costing $1,800 on account.
d. The business painted a house for a client and received $3,000 cash.
e. The business painted a house for a client for $4,000. The client agreed to pay next week.
f. The business paid $800 cash toward the supplies purchased in transaction c.
g. The business paid employee salaries of $1,000 in cash.
h. Richardson withdrew cash of $1,500.
i. The business collected $2,600 from the client in transaction e.
j. David paid $100 cash for personal groceries.

Requirements

1. Analyze the preceding transactions in terms of their effects on the accounting equation of DR Painting. Use Exhibit 1-6 as a guide, but show balances only after the last transaction.

2. Prepare the income statement, statement of owner's equity, and balance sheet of the business after recording the transactions. Use Exhibit 1-7 in the text as a guide.

Chapter 1: Demo Doc Solution

Requirement 1

Analyze the preceding transactions in terms of their effects on the accounting equation of DR Painting. Use Exhibit 1-6 as a guide, but show balances only after the last transaction.

Part 1	Part 2	Part 3	Part 4	Demo Doc Complete

a. DR Painting received $40,000 cash from David Richardson and gave capital to Richardson.

The business is receiving cash from the owner, so this is a recordable transaction for DR Painting.

The business's Cash (an asset) is increased by $40,000 and Richardson, capital (owner's equity) is also increased by $40,000.

The effect of this transaction on the accounting equation is as follows:

	Assets	=	Liabilities +	Owner's Equity (OE)	Type of OE Transaction
	Cash	=		Richardson, capital	
a.	+40,000			+40,000	*Owner investment*
	40,000	=		40,000	

To record this in the table, we add $40,000 under Assets (Cash) and add $40,000 under Owner's Equity (Richardson, capital). To the right of the transaction, we write "Owner investment" to help us keep track of changes in the equity of the business. Before we move on, we should double-check to see that the left side of the equation equals the right side. It is important to remember that the equation must always balance after each transaction is recorded.

b. The business paid $20,000 cash to acquire a truck.

The Truck (an asset) is increased by $20,000, while Cash (an asset) decreases by $20,000.

The effect of this transaction on the accounting equation is as follows:

	Assets		=	Liabilities +	Owner's Equity	Type of OE Transaction
	Cash +	Truck	=		Richardson, capital	
Bal	40,000		=		40,000	
b.	−20,000	+20,000				
Bal	20,000	20,000	=		40,000	
	40,000		=	40,000		

Note that transactions do not have to affect both sides of the equation. However, the accounting equation *always* equals, so *both sides must always balance*. It helps to check that this is true after every transaction.

c. The business purchased supplies costing $1,800 on account.

The supplies are an asset that is increased by $1,800. However, the supplies were not paid for in cash, but instead *on account*. This relates to accounts *pay*able (because it will have to be *paid* later). Because we now owe *more* money that has to be paid later, it is an increase to Accounts payable (a liability) of $1,800.

The effect of this transaction on the accounting equation is as follows:

	Assets			=	Liabilities +	Owner's Equity	Type of OE Transaction
	Cash +	Supplies +	Truck	=	Accounts payable +	Richardson, capital	
Bal	20,000		20,000			40,000	
c.		+1,800			+1,800		
Bal	20,000	1,800	20,000	=	1,800	40,000	
			41,800	=	41,800		

Remember that the supplies will be recorded as an asset until the time that they are used by the business (the adjustment will be addressed in a later chapter). The obligation to pay the $1,800 will remain in Accounts payable until it is paid.

d. The business painted a house for a client and received cash of $3,000.

When the business paints houses, it means that it is doing work, or performing services for clients, which is the way that the business makes money. By performing services, the business is earning service revenues.

This means that there is an increase in Service revenue (which increases Richardson, capital) of $3,000. Because the clients paid in cash, there is also an increase in Cash (an asset) of $3,000.

Remember: Revenues *increase* net income, which increases owner's equity (Richardson, capital).

The effect of this transaction on the accounting equation is as follows:

	ASSETS			=	LIABILITIES +	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash	+ Supplies +	Truck	=	Accounts payable +	Richardson, capital	
Bal	20,000	1,800	20,000	=	1,800	40,000	
d.	+3,000					+3,000	*Service revenue*
Bal	23,000	1,800	20,000	=	1,800	43,000	
			44,800	=	*44,800*		

Note that we write "Service revenue" to the right of the Richardson, capital column to record the type of transaction.

e. The business painted a house for a client for $4,000. The client agreed to pay next month.

This transaction is similar to transaction **d**, except that the business is not receiving the cash immediately. Does this mean that we should wait to record the revenue until the cash is received? No, DR Painting should recognize the revenue when the service is performed, regardless of whether it has received the cash.

Again, the business is performing services for clients, which means that it is earning service revenues. This results in an increase to Service revenue (Richardson, capital) of $4,000.

However, this time the client did not pay in cash but instead agreed to pay later. This is the same as charging the services *on account*. This is money that the business will *receive* in the future (when the customers eventually pay), so it is called accounts *receivable*. Accounts receivable (an asset) is increasing by $4,000. Accounts receivable represents amounts owed to the business and decreases when a customer pays.

The effect of this transaction on the accounting equation is as follows:

	ASSETS				=	LIABILITIES +	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash	+ Accounts receivable +	Supplies +	Truck	=	Accounts payable +	Richardson, capital	
Bal	23,000		1,800	20,000		1,800	43,000	
e.		+4,000					+4,000	*Service revenue*
Bal	23,000	4,000	1,800	20,000	=	1,800	47,000	
				48,800	=	*48,800*		

f. The business paid $800 cash toward the supplies purchased in transaction c.

Think of Accounts payable (a liability) as a list of companies to which the business will *pay* money at some point in the future. In this particular problem, the business owes money to the company from which it purchased supplies on account in transaction c. When the business *pays* the money in full, it can cross this company off of the list. Right now, the business is paying only *part* of the money owed.

This is a decrease to Accounts payable (a liability) of $800 and a decrease to Cash (an asset) of $800. Because the business is only paying part of the money it owes to the supply store, the balance of Accounts payable is $1,800 – $800 = $1,000.

You should note that this transaction does not affect Supplies because we are not buying more supplies. We are simply paying off a liability, not acquiring more assets or incurring a new expense.

The effect of this transaction on the accounting equation is as follows:

	ASSETS				=	LIABILITIES +	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash +	Accounts receivable +	Supplies +	Truck	=	Accounts payable +	Richardson, capital	
Bal	23,000	4,000	1,800	20,000		1,800	47,000	
f.	–800					–800		
Bal	22,200	4,000	1,800	20,000	=	1,000	47,000	
				48,000	=	48,000		

g. The business paid employee salaries of $1,000 cash.

The work the employees have given to the business has *already been used.* By the end of March, DR Painting has had the employees working and painting for customers for the entire month. This means that the *benefit* of the work has already been received. This means that it is a salary *expense.* So, Salary expense would increase by $1,000, which is a decrease to owner's equity.

Remember: Expenses *decrease* net income, which decreases Richardson, capital.

The salaries were paid in cash, so Cash (an asset) is also decreased by $1,000.

The effect of this transaction on the accounting equation is as follows:

	ASSETS				=	LIABILITIES +	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash +	Accounts receivable +	Supplies +	Truck	=	Accounts payable +	Richardson, capital	
Bal	22,200	4,000	1,800	20,000		1,000	47,000	
g.	–1,000						–1,000	*Salary expense*
Bal	21,200	4,000	1,800	20,000	=	1,000	46,000	
				47,000	=	47,000		

h. Richardson withdrew cash of $1,500.

When the business pays cash, it is a recordable transaction. In this case, there is a decrease of $1,500 to Cash (an asset). David is the owner of the proprietorship and is being given some of his value/ownership in cash. In other words, some of the *earnings* that were *retained* by the business are now being distributed to the owner. This results in a decrease of $1,500 to owner's equity, because Richardson, capital is decreasing.

You should note that *drawings are not an expense* because the cash is not used for operations. The cash drawings are for the owner's personal use rather than to earn revenue for the business.

The effect of this transaction on the accounting equation is as follows:

	ASSETS				=	LIABILITIES	+	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash	+ Accounts receivable	+ Supplies	+ Truck	=	Accounts payable	+	Richardson, capital	
Bal	21,200	4,000	1,800	20,000		1,000		46,000	
h.	−1,500							−1,500	*Owner withdrawal*
Bal	19,700	4,000	1,800	20,000	=	1,000		44,500	
				45,500	=	45,500			

i. The business collected $2,600 from the client in transaction e.

Think of Accounts receivable (an asset) as a list of clients from whom the business will *receive* money at some point in the future. Later, when the business collects (*receives*) the cash in full from any particular customer, it can cross that customer off the list.

In transaction e, DR Painting performed services for a client on account. Now, DR is receiving part of that money. This is a collection that decreases Accounts receivable (an asset) by $2,600.

Because the cash is received, this is an increase to Cash (an asset) of $2,600.

The effect of this transaction on the accounting equation is as follows:

	ASSETS				=	LIABILITIES	+	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash	+ Accounts receivable	+ Supplies	+ Truck	=	Accounts payable	+	Richardson, capital	
Bal	19,700	4,000	1,800	20,000		1,000		44,500	
i.	+2,600	−2,600							
Bal	22,300	1,400	1,800	20,000	=	1,000		44,500	
				45,500	=	45,500			

j. David paid $100 cash for personal groceries.

David is using $100 of *his own cash* for groceries. This is a *personal* expense for David's *personal* use that does not relate to the business and therefore is not a recordable transaction for the business. This transaction has no effect on the business's accounting equation. Had David used the *business's* cash to purchase groceries, *then* the business would record the transaction.

	ASSETS				=	LIABILITIES +	OWNER'S EQUITY (OE)	TYPE OF OE TRANSACTION
	Cash	+ Accounts receivable	+ Supplies +	Truck	=	Accounts payable +	Richardson, capital	
a.	+$40,000						+40,000	*Owner investment*
b.	–$20,000			+$20,000				
c.			+$1,800			+$1,800		
d.	+$3,000						+$ 3,000	*Service revenue*
e.		+$4,000					+4,000	*Service revenue*
f.	–$800					–$800		
g.	–$1,000						–$ 1,000	*Salary expense*
h.	–$1,500						–$ 1,500	*Owner withdrawal*
i.	+$2,600	–$2,600						
j.	Not a transaction of business							
Bal	$22,300	$1,400	$1,800	$20,000	=	$1,000	$44,500	
				$45,500	=	$45,500		

Requirement 2

Prepare the income statement, statement of owner's equity, and balance sheet of the business after recording the transactions. Use Exhibit 1-7 in the text as a guide.

Part 1	Part 2	Part 3	Part 4	Demo Doc Complete

Income Statement

The income statement is the first statement that can be prepared because the other financial statements rely upon the net income number calculated on the income statement.

The income statement reports the profitability of the business. To prepare an income statement, begin with the proper heading. A proper heading includes the name of the company (DR Painting), the name of the statement (Income Statement), and the time period covered (Month Ended March 31, 2014). Notice that we are reporting income for a period of time, rather than a single date.

The income statement lists all revenues and expenses. It uses the following formula to calculate net income:

Revenues – Expenses = Net Income

First, you should list revenues. Second, list the expenses. Having trouble finding the revenues and expenses? Look in the equity column of the accounting equation. After you have listed and totaled the revenues and expenses, you subtract the total expenses from total revenues to determine net income or net loss. If you have a positive number, then you will record net income. A negative number indicates that expenses exceeded revenues, and you will record this as a net loss.

In the case of DR Painting, transactions d and e increased Service revenue (by $3,000 and $4,000, respectively). This means that total Service revenue for the month was $3,000 + $4,000 = $7,000.

The only expenses that were incurred were in transaction g, which resulted in a Salary expense of $1,000. On the income statement, these would be recorded as follows:

DR PAINTING
Income Statement
Month Ended March 31, 2014

Revenue:		
Service revenue		$7,000
Expenses:		
Salary expense	$1,000	
Total expenses		1,000
Net income		$6,000

Note the result is a net income of $6,000 ($7,000 – $1,000 = $6,000). You will use this amount on the statement of owner's equity.

Part 1	Part 2	**Part 3**	Part 4	Demo Doc Complete

Statement of Owner's Equity

The statement of owner's equity shows the changes in the owner's capital for a period of time. To prepare a statement of owner's equity, begin with the proper heading. A proper heading includes the name of the company (DR Painting), the name of the statement (Statement of Owner's Equity), and the time period covered (Month Ended March 31, 2014). As with the income statement, we are reporting capital for a period of time, rather than a single date.

Net income is used on the statement of owner's equity to calculate the new balance in the owner's capital account. This calculation uses the following formula:

Beginning Capital
+ Owner investment
+ Net Income (or – Net Loss)
– Drawing
Ending Capital

Start the body of the statement of owner's equity with the Richardson, capital account balance at the beginning of the period (March 1). In this case, because this is a new company, the beginning Richardson, capital is zero. Next, add the owner investment during March of $40,000. Then, add net income as reported on the income statement, $6,000. Following net income, you will add the amounts on the statement so far, $46,000. Then, list the drawing by the owner of $1,500 from transaction h, which reduces capital. Finally, total all amounts and compute the balance at the end of the period. The statement of owner's equity follows:

DR PAINTING
Statement of Owner's Equity
Month Ended March 31, 2014

Richardson, capital, March 1, 2014	$ 0
Owner investment	40,000
Net income for the month	6,000
	46,000
Drawing	(1,500)
Richardson, capital, March 31, 2014	$ 44,500

Note the result is a balance of $44,500 ($40,000 + $6,000 – $1,500 = $44,500) for Richardson, capital. You will use this amount on the balance sheet.

Part 1	Part 2	Part 3	**Part 4**	Demo Doc Complete

Balance Sheet

The balance sheet reports the financial position of the business. To prepare a balance sheet, begin with the proper heading. A proper heading includes the name of the company (DR Painting), the name of the statement (Balance Sheet), and the specific date (March 31, 2014). Unlike the income statement and statement of owner's equity, we are reporting the financial position of the company for a specific date rather than a period of time.

The balance sheet is a listing of all assets, liabilities, and equity, with the accounting equation verified at the bottom.

To prepare the body of the statement, begin by listing assets. Then you will record liabilities and owner's equity. Notice that the balance sheet is organized in the same order as the accounting equation. You should note that the amount of Richardson, capital comes directly from the ending Richardson, capital on the statement of owner's equity. You should then total both sides to make sure that they are equal. If they are not equal, then you will need to look for an error.

In this case, assets include the cash balance of $22,300, accounts receivable of $1,400, $1,800 worth of supplies, and the truck's cost of $20,000, for a total of $45,500 in assets. Liabilities total $1,000, the balance of the Accounts payable account. The figures for assets and liabilities come directly from the accounting equation worksheet. From the statement of owner's equity, we have ending Richardson, capital of $44,500. This gives us a total for liabilities and equity of $1,000 + $44,500 = $45,500, confirming that assets = liabilities + equity.

DR PAINTING
Balance Sheet
March 31, 2014

Assets		Liabilities	
Cash	$22,300	Accounts payable	$ 1,000
Accounts receivable	1,400		
Supplies	1,800	**Owner's Equity**	
Truck	20,000	Richardson, capital	44,500
Total assets	$45,500	Total liabilities and owner's equity	$45,500

Part 1	Part 2	Part 3	Part 4	**Demo Doc Complete**

Review Accounting and the Business Environment

Accounting Vocabulary

Account Payable (p. 15)
A liability backed by the general reputation and credit standing of the debtor.

Account Receivable (p. 15)
The right to receive cash in the future from customers to whom the business has sold goods or for whom the business has performed services.

Accounting (p. 2)
The information system that measures business activities, processes that information into reports, and communicates the results to decision makers.

Accounting Equation (p. 11)
The basic tool of accounting, measuring the resources of the business and the claims to those resources: Assets = Liabilities + Equity.

Articles of Incorporation (p. 6)
The rules approved by the state that govern the management of the corporation.

Asset (p. 11)
An economic resource that is expected to be of benefit in the future.

Audit (p. 5)
An examination of a company's financial records.

Authorization (p. 7)
The acceptance by the state of the Corporate by-laws.

Balance Sheet (p. 20)
An entity's assets, liabilities, and owner's equity as of a specific date. Also called the **statement of financial position.**

Capital (p. 12)
The net amount invested in the business by the owner.

Certified Management Accountant (CMA) (p. 4)
A certified accountant who works for a single company.

Certified Public Accountants (CPAs) (p. 4)
Licensed accountants who serve the general public rather than one particular company.

Charter (p. 6)
Document that gives the state's permission to form a corporation.

Common Stock (p. 13)
Represents the basic ownership of every corporation.

Contributed Capital (p. 13)
The amount invested in a corporation by its owners, the stockholders. Also called **paid-in capital.**

Corporation (p. 6)
A business owned by stockholders. A corporation begins when the state approves its articles of incorporation and the first share of stock is issued. It is a legal entity, an "artificial person," in the eyes of the law.

Cost Principle (p. 10)
A principle that states that acquired assets and services should be recorded at their actual cost.

Creditors (p. 3)
Those to whom a business owes money.

Drawing (p. 12)
Distributions of capital by a company to its owner.

Entity (p. 10)
An organization or a section of an organization that, for accounting purposes, stands apart from other organizations and individuals as a separate economic unit.

Equity (p. 11)
The claim of a company's owners to the assets of the business. Also called **owner's equity** for proprietorships and partnerships and called **shareholders' equity** or **stockholders' equity** for a corporation.

Expenses (p. 12)
Decrease in equity that occurs from using assets or increasing liabilities in the course of delivering goods or services to customers.

Faithful Representation Principle (p. 10)
Principle that asserts accounting information is based on the fact that the data faithfully represents the measurement or description of that data. Faithfully represented data are complete, neutral, and free from material error.

Fiduciary Responsibility (p. 7)
An ethical and legal obligation to perform a person's duties in a trustworthy manner.

Financial Accounting (p. 2)
The branch of accounting that focuses on information for people outside the firm.

Financial Accounting Standards Board (FASB) (p. 4)
The private organization that determines how accounting is practiced in the United States.

Financial Statements (p. 2)
Documents that report on a business in monetary amounts, providing information to help people make informed business decisions.

Generally Accepted Accounting Principles (GAAP) (p. 4)
Accounting guidelines, formulated by the Financial Accounting Standards Board, that govern how accountants measure, process, and communicate financial information.

Going-Concern Concept (p. 10)
This concept assumes that the entity will remain in operation for the foreseeable future.

Income Statement (p. 20)
Summary of an entity's revenues, expenses, and net income or net loss for a specific period. Also called the **statement of earnings** or the **statement of operations.**

International Accounting Standards Board (p. 4)
The organization that determines how accounting is practiced internationally.

International Financial Reporting Standards (IFRS) (p. 4)
Accounting guidelines, formulated by the International Accounting Standards Board, that govern how accountants measure, process, and communicate financial information.

Liabilities (p. 11)
Economic obligations (debts) payable to an individual or an organization outside the business.

Limited-Liability Company (p. 6)
Company in which each member is only liable for his or her own actions or those under his or her control.

Limited-Liability Partnership (p. 6)
Company in which each partner is only liable for his or her own actions or those under his or her control.

Managerial Accounting (p. 2)
The branch of accounting that focuses on information for internal decision makers of a business.

Mutual Agency (p. 6)
The ability of partners in a partnership to commit other partners and the business to a contract.

Net Income (p. 12)
Excess of total revenues over total expenses. Also called **net earnings** or **net profit**.

Net Loss (p. 12)
Excess of total expenses over total revenues.

Not-for-Profit (p. 6)
Organization that has been approved by the Internal Revenue Service to operate for a religious, charitable, or educational purpose.

Owner's Equity (p. 11)
The claim of a company's owners to the assets of the business. For a corporation, owner's equity is called **shareholders'** or **stockholders' equity**.

Paid-In Capital (p. 13)
The amount invested in a corporation by its owners, the stockholders. Also called **contributed capital**.

Partnership (p. 6)
A business with two or more owners and not organized as a corporation.

Proprietorship (p. 6)
A business with a single owner.

Retained Earnings (p. 13)
The amount earned over the life of a business by income-producing activities and kept (retained) for use in the business.

Revenue (p. 12)
Amounts earned by delivering goods or services to customers. Revenues increase capital.

Shareholder (p. 6)
A person who owns stock in a corporation. Also called a **stockholder**.

Shareholders' Equity (p. 11)
The claim of a corporation's owners to the assets of the business. Also called **stockholders' equity**.

Stable Monetary Unit Concept (p. 11)
The concept that says that accountants assume that the dollar's purchasing power is stable.

Statement of Cash Flows (p. 20)
Report of cash receipts and cash payments during a period.

Statement of Earnings (p. 21)
Summary of an entity's revenues, expenses, and net income or net loss for a specific period. Also called the **income statement** or the **statement of operations**.

Statement of Financial Position (p. 21)
An entity's assets, liabilities, and owner's equity as of a specific date. Also called the **balance sheet**.

Statement of Operations (p. 21)
Summary of an entity's revenues, expenses, and net income or net loss for a specific period. Also called the **income statement** or **statement of earnings**.

Statement of Owner's Equity (p. 20)
Summary of the changes in an owner's capital account during a specific period.

Stock (p. 6)
A certificate representing ownership interest in a corporation. The holders of stock are called **stockholders** or **shareholders**.

Stockholder (p. 6)
A person who owns stock in a corporation. Also called a **shareholder**.

Stockholders' Equity (p. 11)
The claim of a corporation's owners to the assets of the business. Also called **shareholders' equity**.

Transaction (p. 13)
An event that affects the financial position of a particular entity and can be measured and recorded reliably.

Destination: Student Success

Student Success Tips

The following are hints on some common trouble areas for students in this chapter:

- The four financial statements are prepared in this order: Income statement, statement of owner's equity, balance sheet, statement of cash flows.
- The accounting equation contains the same accounts as the balance sheet: Assets = Liabilities + Equity.
- Business forms vary, but the goal of accounting is to provide information to users of financial information.
- The accounting concepts are guidelines that help us record business activities.

Getting Help

If there's a learning objective from the chapter you aren't confident about, try using one or more of the following resources:

- Review the Chapter 1 Demo Doc located on page 28 of the textbook.
- Practice additional exercises or problems at the end of Chapter 1 that cover the specific learning objective you are working on.
- Watch the white board videos for Chapter 1, located at myaccountinglab.com under the Chapter Resources button.
- Go to myaccountinglab.com and select the Study Plan button. Choose Chapter 1 and work the questions covering that specific learning objective until you've mastered it.
- Work the Chapter 1 pre/post tests in myaccountinglab.com.
- Consult the Check Figures for End of Chapter starters, exercises, and problems, located at myaccountinglab.com.
- Visit the learning resource center on your campus for tutoring.

• Quick Check

Experience the Power of Practice!

As denoted by the logo, all of these questions, as well as additional practice materials, can be found in **MyAccountingLab**.

Please visit myaccountinglab.com

1. Generally accepted accounting principles (GAAP) are formulated by the
   a. Financial Accounting Standards Board (FASB).
   b. Securities and Exchange Commission (SEC).
   c. Institute of Management Accountants (IMA).
   d. American Institute of Certified Public Accountants (AICPA).
2. Which type of business organization is owned by one owner?
   a. Corporation
   b. Partnership
   c. Proprietorship
   d. Items a, b, and c are all correct.
3. Which accounting concept or principle specifically states that we should record transactions at amounts that can be verified?
   a. Faithful representation
   b. Cost principle
   c. Entity concept
   d. Going-concern concept
4. Fossil is famous for fashion wristwatches and leather goods. At the end of a recent year, Fossil's total assets added up to $363,000,000, and equity was $228,000,000. How much were Fossil's liabilities?
   a. Cannot determine from the data given
   b. $363,000,000
   c. $135,000,000
   d. $228,000,000
5. Assume that Fossil sold watches to a department store on account for $48,000. How would this transaction affect Fossil's accounting equation?
   a. Increase both assets and liabilities by $48,000
   b. Increase both assets and equity by $48,000
   c. Increase both liabilities and equity by $48,000
   d. No effect on the accounting equation because the effects cancel out
6. Accounting is the information system that
   a. measures business activity.
   b. communicates the results to decision makers.
   c. processes data into reports.
   d. All of the above
7. Which of the following is least likely to be a user of a business's financial information?
   a. Taxing authorities
   b. Customers
   c. Creditors
   d. Investors
8. Consider the overall effects on Fossil of selling watches on account for $64,000 and paying expenses totaling $25,000. What is Fossil's net income or net loss?
   a. Net income of $39,000
   b. Net loss of $39,000
   c. Net income of $64,000
   d. Cannot determine from the data given
9. The balance sheet reports
   a. financial position on a specific date.
   b. results of operations on a specific date.
   c. financial position for a specific period.
   d. results of operations for a specific period.

10. Which of the following characteristics best describes a corporation?
    a. Mutual agency
    b. A board of investors
    c. Limited liability of stockholders
    d. Not for profit

Answers are given after Apply Your Knowledge (p. 61).

Assess Your Progress

• Short Exercises

MyAccountingLab

S1-1 ❶ **Explaining revenues and expenses [5 min]**
Sherman Lawn Service has been open for one year, and Hannah Sherman, the owner, wants to know whether the business earned a net income or a net loss for the year. First, she must identify the revenues earned and the expenses incurred during the year.

Requirements

1. What are *revenues* and *expenses*?
2. If revenues increase, what would be the effect, if any, on equity?

S1-2 ❷ **Users of financial information [5 min]**
Suppose you are the manager of Greg's Tunes. The company needs a bank loan in order to purchase music equipment. In evaluating the loan request, the banker asks about the assets and liabilities of the business. In particular, the banker wants to know the amount of the business's owner's equity.

Requirements

1. Is the banker considered an internal or external user of financial information?
2. Which financial statement would provide the best information to answer the banker's questions?

S1-3 ❸ **Organizations that govern CPAs [5–10 min]**
Suppose you are starting a business, Wholly Shirts, to imprint logos on T-shirts. In organizing the business and setting up its accounting records, you take your information to a CPA to prepare financial statements for the bank. You state to the CPA, "I really need to get this loan, so be sure you make my financial statements look great."

Requirement

1. Name the organization that governs the majority of the guidelines that the CPA will use to prepare financial statements for Wholly Shirts.

S1-4 ❹ **Types of business organizations [5–10 min]**
Chloe Michaels plans on opening Chloe Michaels Floral Designs. She is considering the various types of business organizations and wishes to organize her business with unlimited life and limited liability features. Additionally, Chloe wants the option to raise additional equity easily in the future.

Requirement

1. Which type of business organization will meet Chloe's needs best?

S1-5 **5 Organizing a proprietorship [5–10 min]**

You begin No Limits Cell Service by investing $10,000 of your own money in a business bank account. You receive capital. Then the business borrows $5,000 cash by signing a note payable to Summit Bank.

Requirement

1. Identify the advantages and disadvantages of owning a proprietorship.

S1-6 **6 Applying accounting concepts and principles [5–10 min]**

Michael McNamee is the proprietor of a property management company near the campus of Pensacola State College. The business has cash of $8,000 and furniture that cost $9,000 and has a market value of $13,000. Debts include accounts payable of $6,000. Michael's personal home is valued at $400,000 and his personal bank account has a balance of $1,200.

Requirements

1. Consider the accounting principles discussed in the chapter and define the principle that best matches the situation:
   a. Michael's personal assets are not recorded on the property management company's balance sheet.
   b. Michael records furniture at its cost of $9,000, not its market value of $13,000.
   c. Michael does not make adjustments for inflation.
   d. The account payable of $6,000 is documented by a statement from the furniture company showing the business still owes $6,000 on the furniture. Michael's friend thinks he should only owe about $5,000. The account payable is recorded at $6,000.
2. How much equity is in the business?

S1-7 **7 Using the accounting equation [5 min]**

Turtle Creek Kennel earns service revenue by caring for the pets of customers. Turtle Creek's main expense is the salary paid to an employee.

Requirement

1. Write the accounting equation for the following transactions:
   a. Received $320 cash for service revenue earned.
   b. Paid $125 cash for salary expense.
   c. Earned $440 for service revenue, but the customer has not paid Turtle Creek Kennel yet.
   d. Received utility bill of $65, which will be paid next month.

S1-8 **8 Analyzing transactions [5 min]**

Monte Hall Gaming paid $26,000 cash to purchase land.

Requirement

1. Identify which accounts were affected by this transaction and the amount of the change.

S1-9 **8 Analyzing transactions [5 min]**
Getaway Travel recorded revenues of $2,800 earned on account by providing travel service for clients.

Requirements

1. How much are the business's cash and total assets after the transaction?
2. Name the business's asset which was increased as a result of the transaction.

S1-10 **8 Analyzing transactions [5 min]**
Bob Martin Deliveries collected cash on account from a client for whom the business had provided delivery services one month earlier.

Requirements

1. Why didn't the business record revenue when it collected the cash on account?
2. Write two accounting equations to show the effects of
   a. receiving cash of $500 for service revenue earned.
   b. receiving cash of $500 from a customer on account.

S1-11 **9 Prepare the balance sheet [10 min]**
Examine Exhibit 1-6. The exhibit summarizes the transactions of Smart Touch Learning for the month of April 2013. Suppose the business has completed only the first seven transactions and needs a bank loan on April 21. The vice president of the bank requires financial statements to support all loan requests.

Requirement

1. Prepare the balance sheet that the business would present to the banker *after completing the first seven transactions* on April 21, 2013. Exhibit 1-7 shows the format of the balance sheet.

S1-12 **9 Prepare the income statement [10 min]**
Elegant Arrangements has just completed operations for the year ended December 31, 2012. This is the third year of operations for the company. As the owner, you want to know how well the business performed during the year. To address this question, you have assembled the following data:

Insurance expense	$ 4,000	Salary expense	$42,000
Service revenue	74,000	Accounts payable	6,800
Supplies expense	1,100	Supplies	2,100
Rent expense	13,000	Rose, drawing	3,900

Requirement

1. Prepare the income statement of Elegant Arrangements for the year ended December 31, 2012.

Note: Short Exercise 1-13 should be attempted only after completing Short Exercise 1-12.

S1-13 **10 Evaluating business performance [10 min]**
Consider the facts presented in S1-12 for Elegant Arrangements.

Requirements

1. Review the income statement prepared in S1-12. Evaluate the results of 2012 operations for Elegant Arrangements. Was the year good or bad?
2. If the company's service revenue was 20% less than reported in S1-12, how will the net income (loss) change?
3. If the company's salary expense was 20% more than reported in S1-12, how will the net income (loss) change?

Exercises

MyAccountingLab

E1-14 **1 5 6 Using accounting vocabulary [10–15 min]**

Consider the following accounting terms and definitions:

TERMS:	DEFINITIONS:
1. Accounting Equation	A. An economic resource that is expected to be of benefit in the future
2. Asset	B. An economic obligation (a debt) payable to an individual or an organization outside the business
3. Balance Sheet	C. Excess of total expenses over total revenues
4. Expense	D. Excess of total revenues over total expenses
5. Income Statement	E. The basic tool of accounting, stated as Assets = Liabilities + Equity
6. Liability	F. Decrease in equity that occurs from using assets or increasing liabilities in the course of delivering goods or services to customers
7. Net Income	G. Amounts earned by delivering goods or services to customers
8. Net Loss	H. Report of cash receipts and cash payments during a period
9. Revenue	I. Report of an entity's assets, liabilities, and equity as of a specific date
10. Statement of Cash Flows	J. Report of an entity's revenues, expenses and net income/net loss for the period
11. Statement of Owner's Equity	K. Report that shows the changes in capital for a period of time

Requirement

1. Match the term to the correct definition.

E1-15 **2 3 4 9 Users of financial information; the accounting profession, types of business organizations, and preparing the financial statements [15–20 min]**

Evan O'Brien publishes a travel magazine. In need of cash, the business applies for a loan with National Bank. The bank requires borrowers to submit financial statements. With little knowledge of accounting, Evan O'Brien, the proprietor, does not know how to proceed.

Requirements

1. Explain how to prepare the balance sheet and the income statement.
2. Which organization is the privately funded body of accountants that defines pronouncements that guide how the financial statements will be prepared?
3. Indicate why a lender would require this information.
4. What type of organization is Evan O'Brien?
5. If Evan wanted to attract outside investors, which form of business would best enable that option?

E1-16 **5 6 7 Characteristics of a proprietorship, accounting concepts, and using the accounting equation [5–10 min]**

Select financial information for three companies follows:

	Assets	Liabilities	Owner's Equity
New Rock Gas	$?	$24,000	$50,000
DJ Video Rentals	75,000	?	32,000
Corner Grocery	100,000	53,000	?

Requirements

1. Compute the missing amount in the accounting equation for each entity.
2. List the main characteristics of a proprietorship.
3. Which accounting concept tells us that the previous three proprietorships will continue to exist in the future?

E1-17 **6 Comparing U.S. GAAP to IFRS [5–10 min]**

Winged Wheel Garage purchased a parcel of land on January 3, 2012, for $50,000. Its market value at the end of 2012 was $55,000.

Requirements

1. Using the U.S. GAAP cost principle, at what value would the land be reported on the balance sheet as of January 3, 2012? What value would the land be reported at on the December 31, 2012, balance sheet?
2. Using IFRS, at what value would the land be reported on the balance sheet as of January 3, 2012? What value would the land be reported at on the December 31, 2012, balance sheet?

E1-18 **7 8 Using the accounting equation to analyze business transactions [5–10 min]**

Great City Builders balance sheet data at May 31, 2012, and June 30, 2012, follow:

	May 31, 2012	June 30, 2012
Total assets	$177,000	$213,000
Total liabilities	122,000	144,000

Requirement

1. Following are three situations about owner's investments and drawings of the business during June. For each situation, compute the amount of net income or net loss during June 2012.

   a. The owner invested $6,000 in the business and made no withdrawals.
   b. The owner made no investments. The owner withdrew cash of $10,000.
   c. The company owner made investments of $18,000 and withdrew cash of $20,000.

E1-19 **7 8 Using the accounting equation to analyze transactions [5–10 min]**

As the manager of a Papa Sam's restaurant, you must deal with a variety of business transactions.

Requirement

1. Give an example of a transaction that has each of the following effects on the accounting equation:

   a. Increase one asset and decrease another asset.
   b. Decrease an asset and decrease owner's equity.
   c. Decrease an asset and decrease a liability.
   d. Increase an asset and increase owner's equity.
   e. Increase an asset and increase a liability.

E1-20 7 8 **Using the accounting equation to analyze transactions [10–20 min]**

Requirement

1. Indicate the effects of the following business transactions on the accounting equation of a Viviani Video store. Transaction (a) is answered as a guide.

a. Received cash of $8,000 and gave capital.
Answer: Increase asset (Cash)
Increase capital (Viviani, capital)
b. Earned video rental revenue on account, $1,800.
c. Purchased office furniture on account, $400.
d. Received cash on account, $600.
e. Paid cash on account, $100.
f. Sold land for $15,000, which was the cost of the land.
g. Rented videos and received cash of $300.
h. Paid monthly office rent of $900.
i. Paid $200 cash to purchase supplies that will be used in the future.

E1-21 7 8 **Using the accounting equation to analyze transactions [10–20 min]**
Caren Smith opened a medical practice. During July, the first month of operation, the business, titled Caren Smith, M.D., experienced the following events:

Jul	6	Smith invested $55,000 in the business by opening a bank account in the name of C. Smith, M.D. The business gave capital to Smith.
	9	Paid $46,000 cash for land.
	12	Purchased medical supplies for $1,800 on account.
	15	Officially opened for business.
	15–31	During the rest of the month, Smith treated patients and earned service revenue of $8,000, receiving cash.
	29	Paid cash expenses: employees' salaries, $1,600; office rent, $900; utilities, $100.
	30	Returned supplies purchased on the 12th for the cost of those supplies, $700.
	31	Paid $1,100 on account.

Requirement

1. Analyze the effects of these events on the accounting equation of the medical practice of Caren Smith, M.D. Use a format similar to that of Exhibit 1-6, with headings for Cash; Medical supplies; Land; Accounts payable; and Smith, capital.

E1-22 7 8 9 **Using the accounting equation to analyze transactions and calculate net income or net loss [10–15 min]**
The analysis of the first eight transactions of All-in-one Accounting Service follows. The owner made only one investment and there were no owner drawings.

	Cash	+	Accounts receivable	+	Equipment	=	Accounts payable	+	Larrison, capital
1	+ 31,000								+31,000
2			+ 3,800						+ 3,800
3					+ 13,400		+ 13,400		
4	+ 190		– 190						
5	– 410				+ 410				
6	– 8,000						– 8,000		
7	+ 790								+790
8	– 1,500								– 1,500

Requirements

1. Describe each transaction.
2. If these transactions fully describe the operations of All-in-one Accounting Service during the month, what was the amount of net income or net loss?

E1-23 **7 10 Using the accounting equation and evaluating business performance [10 min]**

Bob Auto Repairs started 2012 with total assets of $19,000 and total liabilities of $9,000. At the end of 2012, Bob's total assets stood at $27,000, and total liabilities were $13,000.

Requirements

1. Did the owner's equity of Bob Auto Repairs increase or decrease during 2012? By how much?
2. Identify three possible reasons for the change in owner's equity during the year.

E1-24 **7 9 10 Using the accounting equation, preparing financial statements, and evaluating business performance [10–15 min]**

The 2012 annual report of American Express Services (AES) reported revenue of $21,000,000,000. Total expenses for the year were $14,000,000,000. AES ended the year with total assets of $30,000,000,000, and it owed debts totaling $14,000,000,000. At year-end 2011, the business reported total assets of $23,000,000,000 and total liabilities of $14,000,000,000.

Requirements

1. Compute AES's net income for 2012.
2. Did AES's owner's equity increase or decrease during 2012? By how much?
3. Assume you are a creditor of AES. Would the company's 2012 performance be good or bad for you, as a creditor?

E1-25 **7 9 10 Using the accounting equation, preparing financial statements, and evaluating business performance [30–40 min]**

Compute the missing amount for Felix Company. You will need to work through total owner's equity.

Beginning:		**Owner's Equity:**	
Assets	$45,000	Owner investments	$ 0
Liabilities	29,000	Owner drawings	19,000
Ending:		**Income Statement:**	
Assets	$55,000	Revenues	$242,000
Liabilities	38,000	Expenses	?

Requirements

1. Did Felix earn a net income or suffer a net loss for the year? Compute the amount.
2. Would you consider Felix's performance for the year to be good or bad? Give your reason.

E1-26 **8 Analyzing business transactions [10–15 min]**

Shane's Roasted Peanuts supplies snack foods. The business experienced the following events.

a. Shane's Roasted Peanuts received cash from the owner and gave capital to Shane.
b. Cash purchase of land for a building site.
c. Paid cash on accounts payable.
d. Purchased equipment; signed a note payable.
e. Performed service for a customer on account.
f. Employees worked for the week but will be paid next Tuesday.
g. Received cash from a customer on account receivable.
h. Borrowed money from the bank.
i. Owner withdrew cash.
j. Incurred utility expense on account.

Requirement

1. State whether each event (1) increased, (2) decreased, or (3) had no effect on the *total assets* of the business. Identify any specific asset affected.

E1-27 **9 10 Preparing financial statements and evaluating business performance [10–20 min]**

The account balances of Wilson Towing Service at June 30, 2012, follow:

Equipment	$13,600	Service revenue	$11,200
Supplies	900	Accounts receivable	6,200
Note payable	6,900	Accounts payable	3,000
Rent expense	550	Wilson, capital, Jun 1, 2012	4,950
Cash	2,900	Salary expense	1,900
Wilson, drawing	0		

Requirements

1. Prepare the balance sheet of the business at June 30, 2012.
2. What does the balance sheet report—financial position or operating results?
3. Which financial statement reports the other accounts listed for the business?

E1-28 **9 10 Preparing financial statements and evaluating business performance [10–15 min]**

The assets, liabilities, owner's equity, revenues, and expenses of Davis Design Studio have the following balances at December 31, 2012, the end of its first year of operation. During the year, the owner invested $15,000.

Note payable	$ 42,000	Office furniture	$ 49,000
Rent expense	23,000	Utilities expense	6,900
Cash	3,600	Accounts payable	3,200
Office supplies	4,500	Davis, capital	33,300
Salary expense	65,000	Service revenue	158,300
Salaries payable	2,200	Accounts receivable	8,600
Property tax expense	1,500	Supplies expense	4,200

Requirements

1. Prepare the income statement of Davis Design Studio for the year ended December 31, 2012. What is the result of operations for 2012?
2. What was the amount of the owner drawing during the year?

Problems (Group A)

P1-29A 1 2 3 4 5 6 **Accounting vocabulary, financial statement users, accounting profession, types of business organizations, proprietorship characteristics, and accounting concepts [15–20 min]**

MyAccountingLab

Consider the following terms and definitions:

TERMS:	DEFINITIONS:
1. Proprietorship	A. Feature that enables a corporation to raise more money than proprietorships and partnerships
2. Faithful representation	B. Holds that fair market value should not be used over actual costs
3. Partnership	C. Stands for Financial Accounting Standards Board
4. Stock	D. Owner is referred to as a proprietor
5. Limited liability	E. Asserts that data are complete, neutral, and free from material error
6. Limited Liability Company	F. Revenues of $70,000 and expenses of $85,000
7. Cost principle	G. Has unlimited liability
8. FASB	H. Represents ownership in a corporation
9. Net loss of $15,000	I. Type of entity that is designed to limit personal liability exposure
10. Creditors	J. Person or business lending money

Requirement

1. Match the terms with their correct definitions.

P1-30A 5 6 9 **Proprietorship attributes, applying the entity concept, and preparing financial statements [20–25 min]**

Andrea Scarlett is a realtor. She organized her business as a proprietorship, Andrea Scarlett, Realtor, by investing $19,000 cash. The business gave capital to her. Consider the following facts at September 30, 2012.

a. The business owes $61,000 on a note payable for land that the business acquired for a total price of $83,000.

b. The business spent $23,000 for a Zinka Banker real estate franchise, which entitles the business to represent itself as a Zinka Banker office. This franchise is a business asset.

c. Scarlett owes $80,000 on a personal mortgage for her personal residence, which she acquired in 2012 for a total price of $160,000.

d. Scarlett has $5,000 in her personal bank account, and the business has $9,000 in its bank account.

e. Scarlett owes $4,000 on a personal charge account with Chico's.

f. The office acquired business furniture for $15,000 on September 25. Of this amount, the business owes $2,000 on account at September 30.

g. Office supplies on hand at the real estate office total $1,300.

Requirements

1. Scarlett was concerned about taxes. Which proprietorship feature limits Scarlett's business taxes?
2. Prepare the balance sheet of the real estate business of Andrea Scarlett, Realtor, at September 30, 2012.
3. Identify the personal items that would not be reported on the business records.

P1-31A 6 7 8 9 **Applying the entity concept, using the accounting equation for transaction analysis, and preparing financial statements [20–30 min]**

Alex Shore practiced accounting with a partnership for five years. Recently he opened his own accounting firm, which he operates as a proprietorship. The name of the new entity is Alex Shore, CPA. Shore experienced the following events during the organizing phase of the new business and its first month of operations. Some of the events were personal and did not affect the business.

Feb	4	Shore received $27,000 cash from former accounting partners.*
	5	Deposited $50,000 in a new business bank account titled Alex Shore, CPA. The business gave capital to Shore.
	6	Paid $100 cash for letterhead stationery for the new office.
	7	Purchased office furniture for the office. The business will pay the account payable, $9,700, within three months.
	10	Shore sold personal investment in Amazing.com stock, which he had owned for several years, receiving $50,000 cash.*
	11	Shore deposited the $50,000 cash from sale of the Amazing.com stock in his personal bank account.*
	12	A representative of a large company telephoned Shore and told him of the company's intention to transfer its accounting business to Shore.
	18	Finished tax hearings on behalf of a client and submitted a bill for accounting services, $17,000. Shore expected to collect from this client within two weeks.
	25	Paid office rent, $1,500.
	28	Shore withdrew cash of $1,000.

*Personal transaction of Alex Shore.

Requirements

1. Analyze the effects of the events on the accounting equation of the proprietorship of Alex Shore, CPA. Use a format similar to Exhibit 1-6.
2. As of February 28, compute Alex Shore's
   a. total assets.
   b. total liabilities.
   c. total owner's equity.
   d. net income or net loss for February.

P1-32A 6 7 8 9 10 **Applying the entity concept, using the accounting equation for transaction analysis, preparing financial statements, and evaluating business performance [20–30 min]**

Angela Peters practiced law with a partnership for 10 years. Recently she opened her own law office, which she operates as a proprietorship. The name of the new entity is Angela Peters, Attorney. Peters experienced the following events during the organizing phase of the new business and its first month of operation. Some of the events were personal and did not affect the law practice. Others were business transactions and should be accounted for by the business.

Mar	1	Sold personal investment in eBay stock, which she had owned for several years, receiving $31,000 cash.
	2	Deposited the $31,000 cash from sales of the eBay stock in her personal bank account.
	3	Received $139,000 cash from former law partners.
	5	Deposited $89,000 cash in a new business bank account titled Angela Peters, Attorney. The business gave capital to Peters.
	7	Paid $400 cash for ink cartridges for the printer.
	9	Purchased computer for the law office, agreeing to pay the account, $9,300, within three months.
	23	Finished court hearings on behalf of a client and submitted a bill for legal services, $13,500, on account.
	30	Paid utilities, $1,200.
	31	Peters withdrew cash of $2,000.

Requirements

1. Analyze the effects of the preceding events on the accounting equation of the proprietorship of Angela Peters, Attorney. Use a format similar to Exhibit 1-6.
2. At March 31, compute the business's
   a. total assets.
   b. total liabilities.
   c. total owner's equity.
   d. net income or net loss for the month.

3. Evaluate Angela Peters, Attorney's first month of operations. Were the results good or bad?

P1-33A 7 8 **Using the accounting equation for transaction analysis [20–25 min]**

Zelinsky Electronics was recently formed as a proprietorship. The balance of each item in the company's accounting equation is shown for October 1 and for each of the following business days.

	Cash	Accounts receivable	Supplies	Land	Accounts payable	Zelinsky, capital
Oct 1	$4,000	$7,300	$1,200	$12,800	$4,000	$21,300
4	9,000	7,300	1,200	12,800	4,000	26,300
9	5,000	7,300	1,200	16,800	4,000	26,300
13	5,000	7,300	1,600	16,800	4,400	26,300
16	3,500	7,300	1,600	16,800	2,900	26,300
19	4,800	6,000	1,600	16,800	2,900	26,300
22	9,800	6,000	1,600	16,800	2,900	31,300
25	9,200	6,000	1,600	16,800	2,300	31,300
27	8,400	6,000	2,400	16,800	2,300	31,300
30	2,700	6,000	2,400	16,800	2,300	25,600

Requirement

1. A single transaction took place on each day. Briefly describe the transaction that most likely occurred on each day, beginning with October 4. Indicate which accounts were increased or decreased and by what amounts. Assume that no revenue or expense transactions occurred during the month.

P1-34A 7 8 **Using the accounting equation for transaction analysis [15–25 min]**

Matilda Crone owns and operates a public relations firm called Dance Fever. The following amounts summarize her business on August 31, 2012:

	Assets							=	Liabilities	+	Owner's equity
Date	Cash	+	Accounts receivable	+	Supplies	+	Land	=	Accounts payable	+	Crone, capital
Bal	2,300		1,800		0		14,000		8,000		10,100

During September 2012, the business completed the following transactions:

a. Gave capital to Crone and received cash of $13,000.
b. Performed service for a client and received cash of $900.
c. Paid off the beginning balance of accounts payable.
d. Purchased supplies from OfficeMax on account, $600.
e. Collected cash from a customer on account, $700.
f. Received cash of $1,600 and gave capital to owner.
g. Consulted for a new band and billed the client for services rendered, $5,500.
h. Recorded the following business expenses for the month:
   1. Paid office rent, $1,200.
   2. Paid advertising, $600.
i. Returned supplies to OfficeMax for $110 from item d, which was the cost of the supplies.
j. Crone withdrew cash of $2,000.

Requirement

1. Analyze the effects of the preceding transactions on the accounting equation of Dance Fever. Adapt the format to that of Exhibit 1-6.

P1-35A 9 10 **Preparing financial statements and evaluating business performance [20–30 min]**

Presented here are the accounts of Gate City Answering Service for the year ended December 31, 2012.

Land	$ 8,000	Owner investment, 2012	$ 28,000
Note payable	32,000	Accounts payable	11,000
Property tax expense	2,600	Accounts receivable	1,000
Wayne, drawing	30,000	Advertising expense	15,000
Rent expense	13,000	Building	145,200
Salary expense	65,000	Cash	3,000
Salary payable	1,300	Equipment	16,000
Service revenue	192,000	Insurance expense	2,500
Supplies	10,000	Interest expense	7,000
Wayne, capital, 12/31/2011	54,000		

Requirements

1. Prepare Gate City Answering Service's income statement.
2. Prepare the statement of owner's equity.
3. Prepare the balance sheet.
4. Answer these questions about the company:
   a. Was the result of operations for the year a profit or a loss? How much?
   b. How much in total economic resources does the company have as it moves into the new year?
   c. How much does the company owe to creditors?
   d. What is the dollar amount of the owner's equity in the business at the end of the year?

P1-36A 9 **Preparing financial statements [20–30 min]**

Studio Photography works weddings and prom-type parties. The balance of Ansel, capital was $16,000 at December 31, 2011. At December 31, 2012, the business's accounting records show these balances:

Insurance expense	$ 8,000	Accounts receivable	$ 8,000
Cash	37,000	Note payable	12,000
Accounts payable	7,000	Ansel, capital, Dec 31, 2012	?
Advertising expense	3,000	Salary expense	25,000
Service revenue	80,000	Equipment	50,000
Ansel, drawing	13,000	Owner investment, 2012	29,000

Requirement

1. Prepare the following financial statements for Studio Photography for the year ended December 31, 2012:
   a. Income statement
   b. Statement of owner's equity
   c. Balance sheet

P1-37A 9 10 **Preparing financial statements and evaluating business performance [20–30 min]**

The bookkeeper of Greener Landscaping prepared the company's balance sheet while the accountant was ill. The balance sheet contains numerous errors. In particular, the bookkeeper knew that the balance sheet should balance, so he plugged in the owner's equity amount needed to achieve this balance. The owner's equity is incorrect. All other amounts are right, but some are out of place.

GREENER LANDSCAPING Balance Sheet Month Ended November 30, 2012			
Assets		**Liabilities**	
Cash	$ 4,900	Accounts receivable	$ 2,200
Office supplies	600	Tum, drawing	10,000
Land	34,200	Service revenue	39,000
Salary expense	2,800	Property tax expense	2,600
Office furniture	6,100	Accounts payable	2,700
Note payable	24,200		
Rent expense	300	**Owner's Equity**	
		Tum, capital	16,600
Total assets	$ 73,100	Total liabilities	$ 73,100

Requirements

1. Prepare a corrected balance sheet.
2. Consider the original balance sheet as presented and the corrected balance sheet you prepared for Requirement 1. Did total assets as presented in your corrected balance sheet increase, decrease, or stay the same from the original balance sheet? Why?

• Problems (Group B)

P1-38B 1 2 3 4 5 6 Accounting vocabulary, financial statement users, accounting profession, types of business organizations, proprietorship characteristics, and accounting concepts [15–20 min]

MyAccountingLab

Consider the following terms and definitions:

TERMS:	DEFINITIONS:
1. Proprietorship	A. Feature that sets the maximum amount of financial loss by a stockholder to the cost of the investment
2. Faithful representation	B. Reason why accountants should not write up the value of equipment due to an increase in its fair value
3. Partnership	C. Is composed of accountants
4. Stock	D. An entity that has fewer than two owners
5. Limited liability	E. Principle that does not accept incomplete or bias data
6. Limited Liability Company	F. Revenues of $40,000 and expenses of $25,000
7. Cost principle	G. Possess mutual agency
8. FASB	H. The corporate charter specifies how much of this a corporation can sell
9. Net income of $15,000	I. Entity where the business, and not the proprietor, is liable for the company's debts
10. Business owners	J. Use accounting information to set goals, to measure progress toward those goals, and to make adjustments when needed

Requirement

1. Match the terms with their correct definitions.

P1-39B 5 6 9 Proprietorship attributes, applying the entity concept, and preparing financial statements [20–25 min]

Sandy White is a realtor. She organized her business as a proprietorship, Sandy White, Realtor, by investing $27,000 cash.

The business gave capital to her. Consider the following facts at May 31, 2012:

a. The business owes $62,000 on a note payable for land that the business acquired for a total price of $80,000.
b. The business spent $26,000 for a Minko Banker real estate franchise, which entitles the business to represent itself as a Minko Banker office. This franchise is a business asset.
c. White owes $70,000 on a personal mortgage for her personal residence, which she acquired in 2012 for a total price of $130,000.
d. White has $4,000 in her personal bank account, and the business has $13,000 in its bank account.
e. White owes $3,000 on a personal charge account with **Chico's**.
f. The office acquired business furniture for $20,000 on May 25. Of this amount, the business owes $5,000 on account at May 31.
g. Office supplies on hand at the real estate office total $1,100.

Requirements

1. White was concerned about taxes. Which propriertorship feature limits White's business taxes?
2. Prepare the balance sheet of the real estate business of Sandy White, Realtor at May 31, 2012.
3. Identify the personal items that would not be reported on the business records.

P1-40B **6 7 8 9 Applying the entity concept, using the accounting equation for transaction analysis, and preparing financial statements [20–30 min]**

Arron Woody practiced accounting with a partnership for five years. Recently he opened his own accounting firm, which he operates as a proprietorship. The name of the new entity is Arron Woody, CPA. Woody experienced the following events during the organizing phase of the new business and its first month of operations. Some of the events were personal and did not affect the business.

Feb	4	Woody received $31,000 cash from former accounting partners.*
	5	Deposited $40,000 in a new business bank account titled Arron Woody, CPA. The business gave capital to Woody.
	6	Paid $200 cash for letterhead stationery for the new office.
	7	Purchased office furniture for the office. The business will pay the account payable, $9,500, within three months.
	10	Woody sold personal investment in Amazing.com stock, which he had owned for several years, receiving $51,000 cash.*
	11	Woody deposited the $51,000 cash from sale of the Amazing.com stock in his personal bank account.*
	12	A representative of a large company telephoned Woody and told him of the company's intention to transfer its accounting business to Woody.
	18	Finished tax hearings on behalf of a client and submitted a bill for accounting services, $14,000. Woody expected to collect from this client within two weeks.
	25	Paid office rent, $1,900.
	28	Woody withdrew cash of $8,000.

*Personal transaction of Arron Woody.

Requirements

1. Analyze the effects of the events on the accounting equation of the proprietorship of Arron Woody, CPA. Use a format similar to Exhibit 1-6.
2. As of February 28, compute Arron Woody's
   a. total assets.
   b. total liabilities.
   c. total owner's equity.
   d. net income or net loss for February.

P1-41B 6 7 8 9 10 **Applying the entity concept, using the accounting equation for transaction analysis, preparing financial statements, and evaluating business performance [20–30 min]**

Aimee Griffin practiced law with a partnership for 10 years. Recently she opened her own law office, which she operates as a proprietorship. The name of the new entity is Aimee Griffin, Attorney. Griffin experienced the following events during the organizing phase of the new business and its first month of operation. Some of the events were personal and did not affect the law practice. Others were business transactions and should be accounted for by the business.

Dec 1	Sold personal investment in **eBay** stock, which she had owned for several years, receiving $33,000 cash.
2	Deposited the $33,000 cash from sales of the **eBay** stock in her personal bank account.
3	Received $159,000 cash from former law partners.
5	Deposited $109,000 cash in a new business bank account titled Aimee Griffin, Attorney. The business gave capital to Griffin.
7	Paid $900 cash for ink cartridges for the printer.
9	Purchased a computer for the law office, agreeing to pay the account, $9,200, within three months.
23	Finished court hearings on behalf of a client and submitted a bill for legal services, $17,000, on account.
30	Paid utilities, $1,900.
31	Griffin withdrew cash of $5,000.

Requirements

1. Analyze the effects of the preceding events on the accounting equation of the propriertorship of Aimee Griffin, Attorney. Use a format similar to Exhibit 1-6.
2. At December 31, compute the business's
   a. total assets.
   b. total liabilities.
   c. total owner's equity.
   d. net income or net loss for the month.
3. Evaluate Aimee Griffin, Attorney's first month of operations. Were the results good or bad?

P1-42B 7 8 **Using the accounting equation for transaction analysis [20–25 min]**

Alterri Mechanical was recently formed as a proprietorship. The balance of each item in the company's accounting equation is shown for November 1 and for each of the following business days:

	Cash	Accounts receivable	Supplies	Land	Accounts payable	Alterri, capital
Nov 1	$3,000	$7,300	$ 1,100	$12,000	$4,300	$19,100
4	6,000	7,300	1,100	12,000	4,300	22,100
9	3,000	7,300	1,100	15,000	4,300	22,100
13	3,000	7,300	1,300	15,000	4,500	22,100
16	1,300	7,300	1,300	15,000	2,800	22,100
19	2,200	6,400	1,300	15,000	2,800	22,100
22	10,200	6,400	1,300	15,000	2,800	30,100
25	9,700	6,400	1,300	15,000	2,300	30,100
27	9,100	6,400	1,900	15,000	2,300	30,100
30	3,600	6,400	1,900	15,000	2,300	24,600

Requirement

1. A single transaction took place on each day. Briefly describe the transaction that most likely occurred on each day, beginning with November 4. Indicate which accounts were increased or decreased and by what amounts. Assume that no revenue or expense transactions occurred during the month.

P1-43B 7 8 9 10 **Using the accounting equation for transaction analysis [60–75 min]**
Missy Crone owns and operates a public relations firm called Top 40. The following amounts summarize her business on August 31, 2012:

	Assets								=	Liabilities	+	Owner's equity
Date	Cash	+	Accounts receivable	+	Supplies	+	Land	=		Accounts payable	+	Crone, capital
Bal	2,100	+	2,000	+	0	+	10,000	=		6,000	+	8,100

During September 2012, the business completed the following transactions:

a. Gave capital to Crone and received cash of $10,000.
b. Performed service for a client and received cash of $1,000.
c. Paid off the beginning balance of accounts payable.
d. Purchased supplies from **OfficeMax** on account, $700.
e. Collected cash from a customer on account, $500.
f. Received cash of $1,900 and gave capital to owner.
g. Consulted for a new band and billed the client for services rendered, $5,800.
h. Recorded the following business expenses for the month:
   1. Paid office rent, $900.
   2. Paid advertising, $400.
i. Returned supplies to **OfficeMax** for $80 from item d, which was the cost of the supplies.
j. Crone withdrew cash of $2,700.

Requirement

1. Analyze the effects of the preceding transactions on the accounting equation of Top 40. Adapt the format to that of Exhibit 1-6.

P1-44B 9 10 **Preparing financial statements and evaluating business performance [20–30 min]**
Presented here are the accounts of Quick and EZ Delivery for the year ended December 31, 2012.

Land	$ 7,000	Owner investment, 2012	$ 32,000
Note payable	30,000	Accounts payable	14,000
Property tax expense	2,900	Accounts receivable	1,700
Trott, drawing	32,000	Advertising expense	17,000
Rent expense	13,000	Building	137,900
Salary expense	69,000	Cash	6,000
Salary payable	500	Equipment	17,000
Service revenue	192,000	Insurance expense	2,000
Supplies	8,000	Interest expense	6,000
Trott, capital, 12/31/2011	51,000		

Requirements

1. Prepare Quick and EZ Delivery's income statement.
2. Prepare the statement of owner's equity.
3. Prepare the balance sheet.
4. Answer these questions about the company:
   a. Was the result of operations for the year a profit or a loss? How much?
   b. How much in total economic resources does the company have as it moves into the new year?
   c. How much does the company owe to creditors?
   d. What is the dollar amount of the owner's equity in the business at the end of the year?

P1-45B ⑨ **Preparing financial statements [20–30 min]**

Photo Gallery works weddings and prom-type parties. The balance of Leibovitz, capital was $17,000 at December 31, 2011. At December 31, 2012, the business's accounting records show these balances:

Insurance expense	$ 9,000	Accounts receivable	$ 6,000
Cash	26,000	Note payable	14,000
Accounts payable	4,000	Leibovitz, capital, Dec 31, 2012	?
Advertising expense	2,000	Salary expense	21,000
Service revenue	78,000	Equipment	70,000
Leibovitz, drawing	14,000	Owner investment, 2012	35,000

Requirement

1. Prepare the following financial statements for Photo Gallery for the year ended December 31, 2012:
   a. Income statement
   b. Statement of owner's equity
   c. Balance sheet

P1-46B ⑨ ⑩ **Preparing financial statements and evaluating business performance [20–30 min]**

The bookkeeper of Outdoor Life Landscaping prepared the company's balance sheet while the accountant was ill. The balance sheet contains numerous errors. In particular, the bookkeeper knew that the balance sheet should balance, so he plugged in the owner's equity amount needed to achieve this balance. The owner's equity is incorrect. All other amounts are right, but some are out of place.

OUTDOOR LIFE LANDSCAPING
Balance Sheet
Month Ended July 31, 2012

Assets		Liabilities	
Cash	$ 5,000	Accounts receivable	$ 2,300
Office supplies	800	Kamp, drawing	8,000
Land	28,400	Service revenue	39,200
Salary expense	3,500	Property tax expense	2,000
Office furniture	5,200	Accounts payable	2,800
Note payable	26,400		
Rent expense	700	**Owner's Equity**	
		Kamp, capital	15,700
Total assets	$ 70,000	Total liabilities	$ 70,000

Requirements

1. Prepare a corrected balance sheet.
2. Consider the original balance sheet as presented and the corrected balance sheet you prepared for Requirement 1. Did total assets as presented in your corrected balance sheet increase, decrease, or stay the same from the original balance sheet? Why?

• Continuing Exercise

MyAccountingLab

Exercise 1-47 is the first exercise in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 5.

E1-47 **8 Analyzing transactions [10–15 min]**

Lawlor Lawn Service began operations and completed the following transactions during May 2012:

May	1	Received $1,700 and gave capital to Lawlor. Deposited this amount in bank account titled Lawlor Lawn Service.
	3	Purchased on account a mower, $1,200, and weed whacker, $240. The equipment is expected to remain in service for four years.
	5	Purchased $30 of gas. Wrote check #1 from the new bank account.
	6	Performed lawn services for client on account, $150.
	8	Purchased $150 of fertilizer that will be used on future jobs. Wrote check #2 from the new bank account.
	17	Completed landscaping job for client, received cash $800.
	31	Received $100 on account from May 6 sale.

Requirement

1. Analyze the effects of Lawlor Lawn Service transactions on the accounting equation. Use the format of Exhibit 1-6, and include these headings: Cash; Accounts receivable; Lawn supplies; Equipment; Accounts payable; and Lawlor, capital.

In Chapter 2, we will account for these same transactions a different way—as the accounting is actually performed in practice.

• Continuing Problem

MyAccountingLab

Problem 1-48 is the first problem in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 5.

P1-48 **8 9 Analyzing transactions and preparing financial statements [20–25 min]**

Draper Consulting began operations and completed the following transactions during the first half of December:

Dec	2	Received $18,000 cash and gave capital to Draper.
	2	Paid monthly office rent, $550.
	3	Paid cash for a Dell computer, $1,800. This equipment is expected to remain in service for five years.
	4	Purchased office furniture on account, $4,200. The furniture should last for five years.
	5	Purchased supplies on account, $900.
	9	Performed consulting service for a client on account, $1,500.
	12	Paid utility expenses, $250.
	18	Performed service for a client and received cash of $1,100.

Requirements

1. Analyze the effects of Draper Consulting's transactions on the accounting equation. Use the format of Exhibit 1-6, and include these headings: Cash; Accounts receivable; Supplies; Equipment; Furniture; Accounts payable; and Draper, capital.
2. Prepare the income statement of Draper Consulting for the month ended December 31, 2012.
3. Prepare the statement of owner's equity for the month ended December 31, 2012.
4. Prepare the balance sheet at December 31, 2012.

In Chapter 2, we will account for these same transactions a different way—as the accounting is actually performed in practice.

• Practice Set

8 Analyzing transactions [10–15 min] Consider the following transactional data for the first month of operations of Shine King Cleaning.

Nov 1: Evan Hudson deposited $35,000 in the business account. Also on this date, Evan transferred his truck title, worth $8,000, to the business. Evan received capital in return.

Nov 2: Wrote a check for $2,000 to Pleasant Properties. In the "for" area of the the check, it states "November through February Rent." (Debit Prepaid rent)

Nov 3: Purchased business insurance policy for $2,400 for the term November 1, 2012, through October 31, 2013 and paid cash. (Debit Prepaid insurance)

Nov 4: Evan went to the Cleaning Supply Company and purchased $270 of cleaning supplies on account. The invoice is due 20 days from the date of purchase.

Nov 5: Purchased on account an industrial vacuum cleaner from Penny Purchase costing $1,000. The invoice is payable on or before November 25.

Nov 7: Purchased a computer and printer costing a total of $1,200. A check for the same amount to the computer store was written on the same date.

Nov 9: Performed cleaning services on account for Pierre's Wig Stand in the amount of $3,000.

Nov 10: Deposited Pierre's check for $100 in the bank.

Nov 15: Wrote check payable to Eric Ryder for $500 for contract labor.

Nov 16: Received $3,600 for 1-year contract beginning November 16 for cleaning services to be provided to the Sea Side Restaurant. Contract begins November 16, 2012, and ends November 15, 2013. (Credit Unearned service revenue)

Nov 17: Provided cleaning services for Tip Top Solutions for $800. Tip Top paid with a check.

Nov 18: Received water and electric bill for $175 with due date of December 4, 2012.

Nov 20: Borrowed $40,000 from bank with interest rate of 9% per year.

Nov 21: Deposited check from Pierre's Wig Stand for $900 paid on account.

Nov 25: Wrote check to Penny Purchase for invoice #1035 in the amount of $500.

Nov 29: Wrote check payable to St. Petersburg News for $100 for advertising.

Nov 30: Evan withdrew cash of $600.

Requirement

1. Prepare an analysis of the November activity using the format displayed in Exhibit 1-6 as a guide. Include the following headings: Cash; Accounts receivable, Supplies; Prepaid rent; Prepaid insurance; Truck; Equipment; Accounts payable; Unearned service revenue; Notes payable; and Hudson, capital.

Apply Your Knowledge

• Decision Cases

Decision Case 1-1 Let's examine a case using Greg's Tunes and another company, Sal's Silly Songs. It is now the end of the first year of operations, and both owners—Sally Siegman and Greg Moore—want to know how well they came out at the end of the year. Neither business kept complete accounting records and neither owner made any drawings. Moore and Siegman throw together the following data at year end:

Sal's Silly Songs:	
Total assets	$23,000
Siegman, capital	8,000
Total revenues	35,000
Total expenses	22,000
Greg's Tunes:	
Total liabilities	$10,000
Moore, capital	6,000
Total expenses	44,000
Net income	9,000

Working in the music business, Moore has forgotten all the accounting he learned in college. Siegman majored in English literature, so she never learned any accounting. To gain information for evaluating their businesses, they ask you several questions. For each answer, you must show your work to convince Moore and Siegman that you know what you are talking about.

1. Which business has more assets?
2. Which business owes more to creditors?
3. Which business has more owner's equity at the end of the year?
4. Which business brought in more revenue?
5. Which business is more profitable?
6. Which of the foregoing questions do you think is most important for evaluating these two businesses? Why? (Challenge)
7. Which business looks better from a financial standpoint? (Challenge)

Decision Case 1-2 Dave and Reba Guerrera saved all their married life to open a bed and breakfast (B&B) named Tres Amigos. They invested $100,000 of their own money and the company gave capital to them. The business then got a $100,000 bank loan for the $200,000 needed to get started. The company bought a run-down old Spanish colonial home in Tucson for $80,000. It cost another $50,000 to renovate. They found most of the furniture at antique shops and flea markets—total cost was $20,000. Kitchen equipment cost $10,000, and a Dell computer set cost $2,000.

Prior to the grand opening, the banker requests a report on their activities thus far. Tres Amigos' bank statement shows a cash balance of $38,000. Dave and Reba believe that the $38,000 represents net income for the period, and they feel pretty good about the results of their business. To better understand how well they are doing, they prepare the following income statement for presentation to the bank:

TRES AMIGOS BED AND BREAKFAST Income Statement Six Months Ended June 30, 2013	
Revenues:	
Investments by owner	$100,000
Bank loan	100,000
Total revenues	200,000
Expenses:	
Cost of the house	$ 80,000
Renovation to the house	50,000
Furniture expense	20,000
Kitchen equipment expense	10,000
Computer expense	2,000
Total expenses	162,000
Net income	38,000

1. Suppose you are the Guerreras' banker, and they have given you this income statement. Would you congratulate them on their net income? If so, explain why. If not, how would you advise them to measure the net income of the business? Does the amount of cash in the bank measure net income? Explain.
2. Prepare Tres Amigos' balance sheet from their data. There is no net income or loss yet.

• Ethical Issues

Ethical Issue 1-1 The board of directors of Xiaping Trading Company is meeting to discuss the past year's results before releasing financial statements to the bank. The discussion includes this exchange:

Wai Lee, company owner: "This has not been a good year! Revenue is down and expenses are way up. If we are not careful, we will report a loss for the third year in a row. I can temporarily transfer some land that I own into the company's name, and that will beef up our balance sheet. Brent, can you shave $500,000 from expenses? Then we can probably get the bank loan that we need."

Brent Ray, company chief accountant: "Wai Lee, you are asking too much. Generally accepted accounting principles are designed to keep this sort of thing from happening."

Requirements

1. What is the fundamental ethical issue in this situation?
2. How do the two suggestions of the company owner differ?

Ethical Issue 1-2 The tobacco companies have paid billions because of smoking-related illnesses. In particular, **Philip Morris**, a leading cigarette manufacturer, paid over $3,000,000,000 in one year.

Requirements

1. Suppose you are the chief financial officer (CFO) responsible for the financial statements of **Philip Morris**. What ethical issue would you face as you consider what to report in your company's annual report about the cash payments? What is the ethical course of action for you to take in this situation?
2. What are some of the negative consequences to **Philip Morris** for not telling the truth? What are some of the negative consequences to **Philip Morris** for telling the truth?

Fraud Case 1-1

Exeter is a building contractor on the Gulf Coast. After losing a number of big lawsuits, it was facing its first annual net loss as the end of the year approached. The owner, Hank Snow, was under intense pressure from the company's creditors to report positive net income for the year. However, he knew that the controller, Alice Li, had arranged a short-term bank loan of $10,000 to cover a temporary shortfall of cash. He told Alice to record the incoming cash as "construction revenue" instead of a loan. That would nudge the company's income into positive territory for the year, and then, he said, the entry could be corrected in January when the loan was repaid.

Requirements

1. How would this action affect the year-end income statement? How would it affect the year-end balance sheet?
2. If you were one of the company's creditors, how would this fraudulent action affect you?

Financial Statement Case 1-1

This and similar cases in later chapters focus on the financial statement of a real company—**Amazon.com, Inc.**, the Internet shopping leader. As you work each case, you will gain confidence in your ability to use the financial statements of real companies.

Refer to **Amazon.com's** financial statements in Appendix A at the end of the book.

Requirements

1. How much in cash (including cash equivalents) did **Amazon.com** have on December 31, 2009?
2. What were the company's total assets at December 31, 2009? At December 31, 2008?
3. Write the company's accounting equation at December 31, 2009, by filling in the dollar amounts:

   ASSETS = LIABILITIES + EQUITY

4. Identify net sales (revenue) for the year ended December 31, 2009. How much did total revenue increase or decrease from 2008 to 2009?
5. How much net income or net loss did **Amazon** earn for 2009 and for 2008? Based on net income, was 2009 better or worse than 2008?

Team Projects

Team Project 1-1 You are opening Quail Creek Pet Kennel. Your purpose is to earn a profit, and you organize as a proprietorship.

1. Make a detailed list of 10 factors you must consider to establish the business.
2. Identify 10 or more transactions that your business will undertake to open and operate the kennel.
3. Prepare the Quail Creek Pet Kennel income statement, statement of owner's equity, and balance sheet at the end of the first month of operations. Use made-up figures and include a complete heading for each financial statement. Date the balance sheet as of January 31, 20XX.
4. Discuss how you will evaluate the success of your business and how you will decide whether to continue its operation.

Team Project 1-2 You are promoting a rock concert in your area. Your purpose is to earn a profit, and you organize Concert Enterprises as a proprietorship.

Requirements

1. Make a detailed list of 10 factors you must consider to establish the business.
2. Describe 10 of the items your business must arrange in order to promote and stage the rock concert.
3. Prepare your business's income statement, statement of owner's equity, and balance sheet on June 30, 20XX, immediately after the rock concert. Use made-up amounts, and include a complete heading for each financial statement. For the income statement and the statement of owner's equity, assume the period is the three months ended June 30, 20XX.
4. Assume that you will continue to promote rock concerts if the venture is successful. If it is unsuccessful, you will terminate the business within three months after the concert. Discuss how you will evaluate the success of your venture and how you will decide whether to continue in business.

• Communication Activity 1-1

In 25 words or fewer, illustrate the accounting equation and explain each part of the accounting equation.

Quick Check Answers

1. *a* 2. *c* 3. *a* 4. *c* 5. *b* 6. *d* 7. *b* 8. *a* 9. *a* 10. *c*

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2 Recording Business Transactions

How do the activities of the company affect what it OWNS?

How do the activities of the company affect what it OWES?

SMART TOUCH LEARNING
Balance Sheet
May 31, 2013

Assets			
Current assets:			
Cash		$ 4,800	
Accounts receivable		2,600	
Inventory		30,500	
Supplies		600	
Prepaid rent		2,000	
Total current assets			$ 40,500
Plant assets:			
Furniture	$18,000		
Less: Accumulated depreciation—furniture	300	17,700	
Building	48,000		
Less: Accumulated depreciation—building	200	47,800	
Total plant assets			65,500
Total assets			$106,000

Liabilities	
Current liabilities:	
Accounts payable	$ 48,700
Salary payable	900
Interest payable	100
Unearned service revenue	400
Total current liabilities	50,100
Long-term liabilities:	
Notes payable	20,000
Total liabilities	70,100
Owner's Equity	
Bright, capital	35,900
Total liabilities and owner's equity	$106,000

How do the activities of the company affect its NET WORTH?

Learning Objectives

1. Explain accounts, journals, and ledgers as they relate to recording transactions and describe common accounts
2. Define debits, credits, and normal account balances, and use double-entry accounting and T-accounts
3. List the steps of the transaction recording process
4. Journalize and post sample transactions to the ledger
5. Prepare the trial balance from the T-accounts

After reading Chapter 1, you have a basic understanding of what financial statements are. But how do you create them for your business or the company you work for? How do large companies like **Microsoft** create their statements for investors? How does any business capture the financial events that occur so that it can create financial statements?

In Chapter 1, we saw how Sheena Bright of Smart Touch Learning recorded her company's business transactions in terms of the accounting equation. That procedure works well for a handful of transactions, but it's not very efficient if your business generates lots of transactions. In this chapter, we'll show you a more efficient way to capture