1 Accounting and the Business Environment

Learning Objectives/Success Keys

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. Define and use the accounting equation
8. Depict accounting for business transactions
9. Explain and prepare the financial statements
10. Use financial statements to evaluate business performance

You may dream of running your own business. Where do you begin? How much money does it take? How will you measure success or failure?

Hannah Sherman operated a lawn-service business while in college and graduated with thousands in the bank. Greg Moore started a successful music business. How did they do it? By following their dreams, treating people fairly, and having realistic expectations. It did not hurt that Moore majored in accounting. His accounting knowledge gave him a leg up on organizing the business and keeping track of important details.

We will start with a small business such as Sherman Lawn Service or Greg's Groovy Tunes. What role does accounting play for Sherman Lawn Service or Greg's Groovy Tunes?

Accounting Vocabulary: The Language of Business

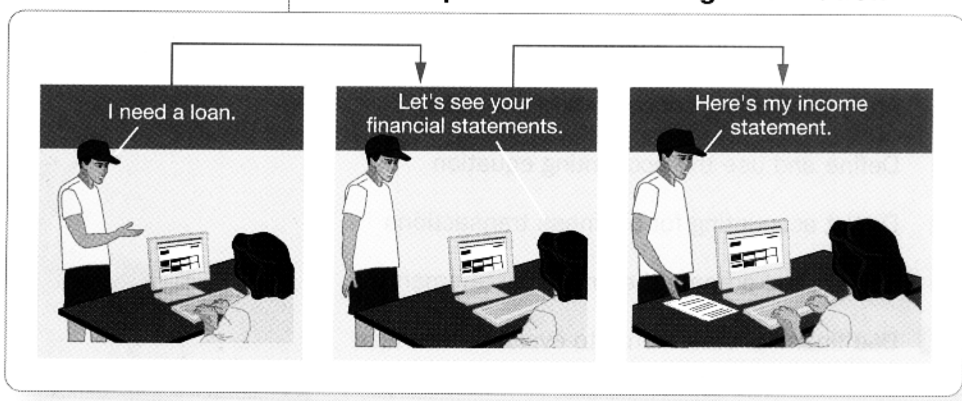
1 Define accounting vocabulary

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 or not to borrow money? You need to consider your income and whether or not you will be able to pay back that loan. The concept of income comes straight from accounting.

A key product of accounting is a set of reports called financial statements. **Financial statements** report on a business in monetary terms. Is Sherman Lawn Service making a profit? Should Greg's Groovy Tunes expand? The financial statements help answer these questions.

Exhibit 1-1 illustrates the role of accounting in business. The process shows people making decisions.

EXHIBIT 1-1 | **How People Use Accounting Information**



Decision Makers: The Users of Accounting Information

2 Define the users of financial information

Decision makers need information. The bigger the decision, the more information decision makers need. Here are some of the ways people use accounting information.

Individuals

You use accounting information to manage your cash, to evaluate a new job, and to decide whether or not you can afford a new computer. Hannah Sherman and Greg Moore make the same decisions that you do.

Businesses

Business owners use accounting information to set goals, to measure progress toward those goals, and to make adjustments when needed. For example, Greg Moore must decide how many microphones he will need for each music concert. Accounting helps provide this information.

Investors

Outside investors often provide the money to get a business going. To decide whether to invest, a person predicts the amount of income to be earned on the investment. The investor then analyzes the financial statements and keeps current with the company. To view the financial statements of large public companies, log on to finance.yahoo.com, finance.google.com or the SEC's EDGAR database.

Creditors

Any person or business that loans money is a **creditor**. Before lending money to Hannah Sherman, a bank evaluates Sherman's ability to make the loan payments. This requires a report on Sherman's predicted income. If you try to borrow money for a new car, the bank will review accounting data to determine your ability to make the car payments.

Taxing Authorities

Local, state, and federal governments levy taxes. Income tax is figured using accounting information. Sales tax depends upon a company's sales.

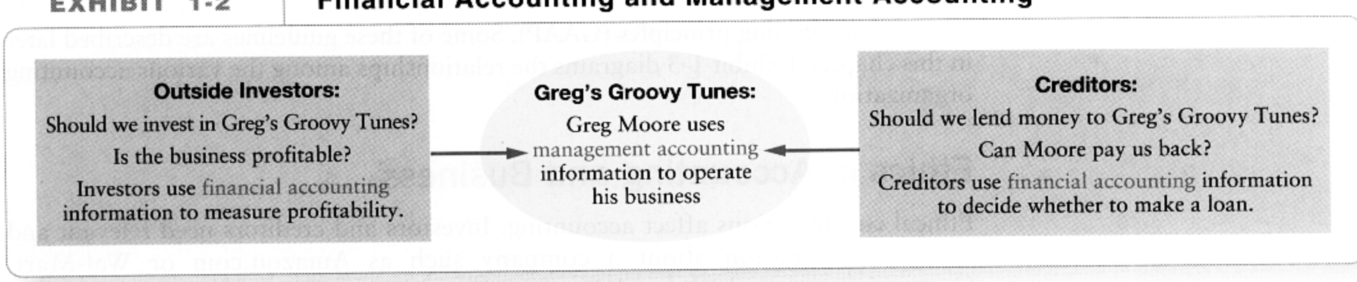
Financial Accounting and Management Accounting

Accounting can be divided into two fields—financial accounting and management accounting.

Financial accounting provides information for external decision makers, such as outside investors and lenders. These outsiders use the company's financial statements. Chapters 2–14 of this book deal primarily with financial accounting.

Management accounting focuses on information for internal decision makers, such as the company's managers. Chapters 15–23 of this book cover management accounting. Exhibit 1-2 illustrates the difference between financial accounting and management accounting.

EXHIBIT 1-2 | **Financial Accounting and Management Accounting**



The Accounting Profession and the Organizations that Govern it

3 Describe the accounting profession and the organizations that govern it

There are several learned professions, including accounting, architecture, engineering, law, and medicine. To be certified in a profession, one must pass a qualifying exam, and professionals are paid quite well. For example, the average starting salary in 2007 for a college graduate with a bachelor's degree in accounting was almost

$44,000. A graduate with a master's degree earns about 10% more to start and **certified public accountants** 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 the large accounting firms earn from $150,000 to $500,000 per year. In private accounting, the top position is called the chief financial officer (CFO), and a CFO earns about as much as a partner in an accounting firm.

What do businesses such as Sherman Lawn Service, Greg's Groovy Tunes, **Wal-Mart,** and the **Coca-Cola Company** have in common? They all need accountants! That is why accounting opens so many doors upon graduation.

Accountants get to the top of organizations as often as anyone else. Why? Because the accountants must deal with everything in the company 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 income, all the expenses, all the cash, all the inventory, and all the debts. 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 us look at the organizations that govern the accounting profession.

Governing Organizations

In the United States the **Financial Accounting Standards Board (FASB)**, a private organization, formulates accounting standards. The FASB works with governmental agencies like the Securities and Exchange Commission (SEC) and 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). **Certified public accountants**, or **CPAs**, are licensed professional accountants who serve the general public. **Certified management accountants**, or **CMAs**, are licensed professionals who work for a single company.

The standards or guidelines for public information are called **generally accepted accounting principles (GAAP)**. Some of these guidelines are described later in this chapter. Exhibit 1-3 diagrams the relationships among the various accounting organizations.

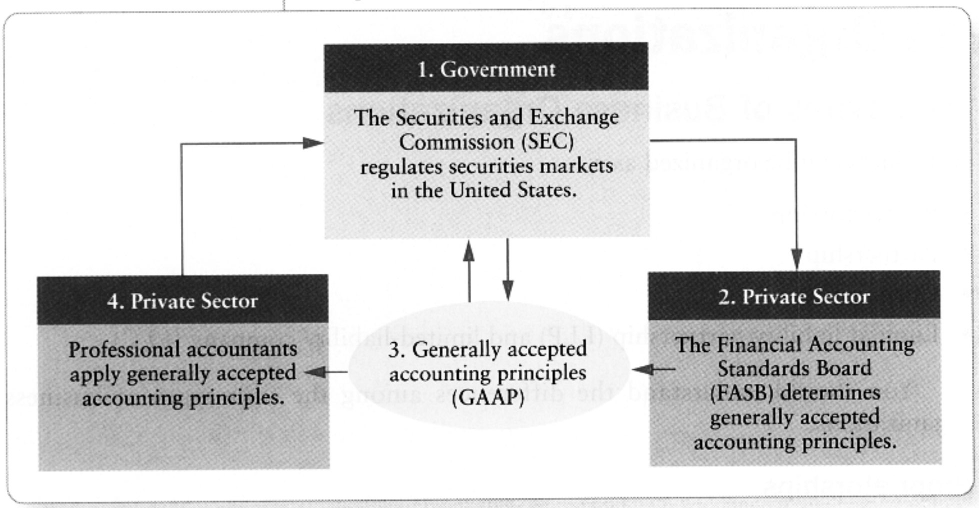
Ethics in Accounting and Business

Ethical considerations affect accounting. Investors and creditors need relevant and reliable information about a company such as **Amazon.com** or **Wal-Mart**. Companies want to look good 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 a financial examination. The independent accountants then tell whether or not the financial statements give a fair picture of the company's 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 more accounting scandals than at any time since the 1920s.

Enron, Corp., for example, was one of the largest companies in the United States before it began reporting misleading data. **WorldCom**, a major long-distance

EXHIBIT 1-3 | **Key Accounting Organizations**



telephone provider, admitted accounting for expenses as though they were **assets** (economic resources). These and other scandals rocked the business community and hurt investor confidence. Innocent people lost their jobs, and the stock market suffered. The U.S. government took swift action. It passed the Sarbanes-Oxley Act that made it a criminal offense to falsify financial statements. It also created a new watchdog agency, the Public Companies Accounting Oversight Board, to monitor the work of independent accountants who audit public companies.

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:

> "[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:

> "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 Groovy Tunes must comply with copyright laws in order to serve customers ethically. **Microsoft** has a highly developed set of business conduct guidelines. 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.

Types of Business Organizations

4 Identify the different types of business organizations

Four Types of Business Organizations

A business can be organized as a

- Proprietorship
- Partnership
- Corporation
- Limited-liability partnership (LLP) and limited-liability company (LLC)

You should understand the differences among the four 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 sole 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. In this book, we start with a proprietorship.

Partnerships

A **partnership** joins two or more individuals as co-owners. Each owner is a partner. 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.

Corporations

A **corporation** is a business owned by **stockholders**, or **shareholders**. These are the people who own shares of stock in the business. A business becomes a corporation when the state approves its articles of incorporation and the first stock share is issued. 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. An investor with no personal relationship to **Coca-Cola** can become a stockholder by buying 50, 100, 5,000, or any number of shares of **Coca-Cola** stock.

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

A **limited-liability partnership** is one in which a wayward partner cannot create a large liability for the other partners. Each partner is liable 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. Today most proprietorships and partnerships are organized as LLCs and LLPs. The limited-liability aspect gives these organizations one of the chief advantages of a corporation. Exhibit 1-4 summarizes the differences among the four types of business organization.

EXHIBIT 1-4 | **Comparison of the Four Forms of Business Organization**

	Proprietorship	Partnership	Corporation	LLC
1. Owner(s)	Proprietorship—only one owner	Partners—two or more owners	Stockholders—generally many owners	Members
2. Life of the organization	Limited by the owner's choice, or death	Limited by the owner's choice, or death	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

*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. Often, small businesses consult other professionals, such as attorneys and accountants for advice.

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. They are described in detail below.

Separate Entity with No Continuous Life

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. Although it is not a distinct entity from a legal perspective, it is an entity that exists apart from its owner.

The ownership interest of a proprietorship is recognized in the owner's capital account. This is listed in the entity's books as NAME OF OWNER, CAPITAL. So, for example, Greg Moore's capital account in the accounting records of Greg's Groovy Tunes would be listed as Greg Moore, Capital. The life of the 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, but stockholders in corporations have limited liability. This liability makes owning a proprietorship very unattractive due to the owner's real fear of losing all of his or her personal wealth because of a business failure.

Unification of Ownership and Management

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

Business Taxation

Proprietorships are not separate taxable entities. The income flows directly from the business 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 (both the employee and employer portions, which are discussed in Chapter 10).

Government Regulation

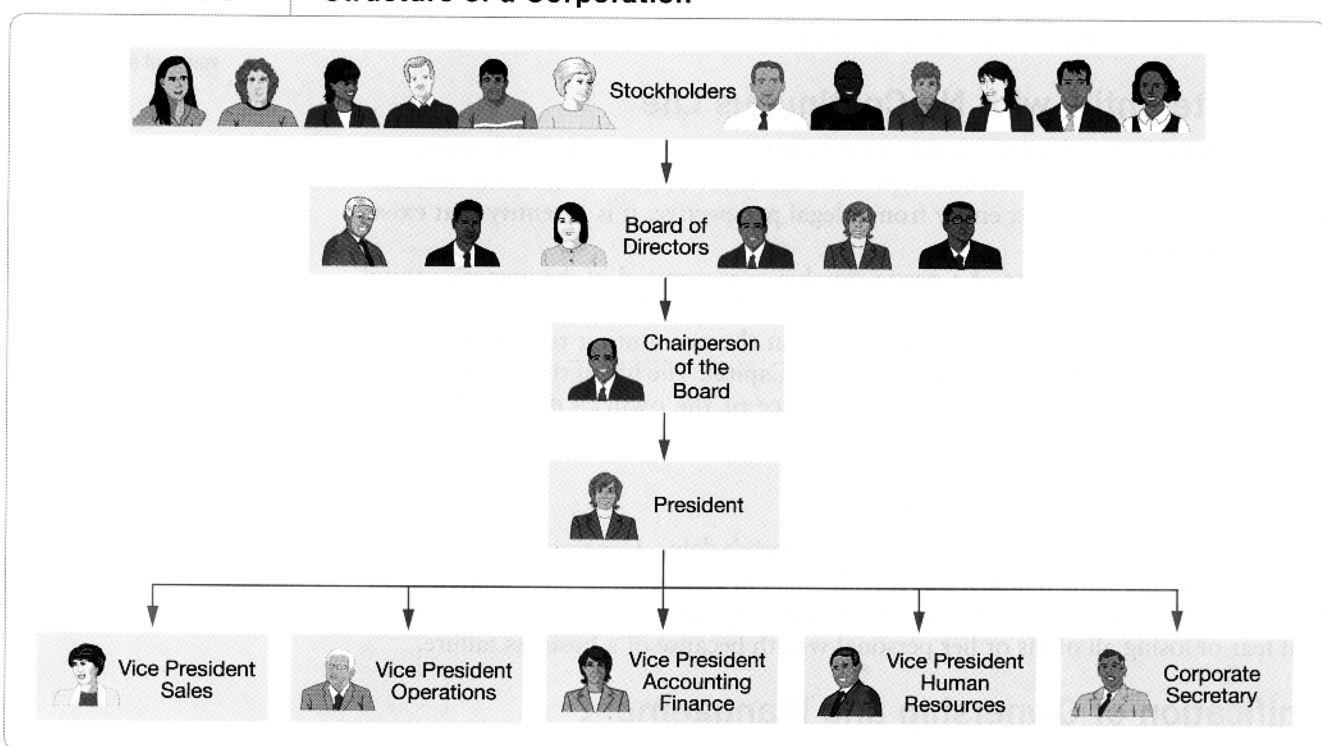
Government regulation is an advantage for the proprietorship. There are no stockholders to notify and no articles of incorporation to follow. Decisions can easily be made by the owner/manager.

Organization of a Corporation

Creation of a corporation is different than a proprietorship. It 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.

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 1-5 shows the authority structure in a corporation.

EXHIBIT 1-5 | **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 the heading 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. We begin the discussion of GAAP by introducing basic accounting concepts and principles.

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.

Consider Sherman Lawn Service. Assume Hannah Sherman started the business with $500 obtained from a bank loan. Following the entity concept, Sherman would account for the $500 separately from her personal assets, such as her clothing and automobile. To mix the $500 of business cash with her personal assets would make it difficult to measure the success or failure of Sherman Lawn Service.

Consider **Toyota**, a huge organization with several divisions. **Toyota** management evaluates each division as a separate entity. If **Lexus** sales are dropping, **Toyota** can find out why. But if sales figures from all divisions of the company are combined, management cannot tell that **Lexus** sales are going down. Thus, *the entity concept applies to any economic unit that needs to be evaluated separately.*

The Reliability (Objectivity) Principle

Accounting information is based on the most reliable data available. This guideline is the **reliability principle**, also called the **objectivity principle**. Reliable data are verifiable, which means they may easily be confirmed by any independent observer. For example, a bank loan is supported by a promissory note. This is objective evidence of the loan. Without the reliability principle, accounting data might be based on whims and opinions.

Suppose Greg Moore transfers a small building to Greg's Groovy Tunes. He believes the building is worth $50,000. A real estate appraiser, however, values the building at $40,000. Which is the more reliable estimate of the building's value, Moore's estimate of $50,000 or the $40,000 professional appraisal? The $40,000 estimate is more reliable because it is supported by a professional appraisal. Greg's Groovy Tunes should record the building at $40,000.

The Cost Principle

The **cost principle** states that acquired assets and services should be recorded at their actual cost (also called *historical cost*). 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. Suppose Moore purchases recording equipment from a supplier that is going out of business. Assume that he gets a good deal and pays only $2,000 for equipment that would have cost him $3,000 elsewhere. The cost principle requires Moore to record the equipment at its actual cost of $2,000, not the $3,000 that he believes the equipment is worth.

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 Moore holds the recording equipment for six months.

During that time recording equipment prices rise, and the equipment can be sold for \$3,500. Should its accounting value—the figure on the books—be the actual cost of \$2,000 or the current market value of \$3,500? By the cost principle, the accounting value of the equipment remains at the actual cost of \$2,000.

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.

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.

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 food and less gas for your car. But accountants assume that the dollar's purchasing power is stable. This assumption is the basis of the **stable monetary unit concept.**

The Accounting Equation

7 Define and use the accounting equation

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. They are something you own that has value. Cash, merchandise inventory, furniture, and land are assets.

Claims to those assets come from two sources. **Liabilities** are debts payable to outsiders who are known as creditors. They are something you owe. For example, a creditor who has loaned money to Greg's Groovy Tunes 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.

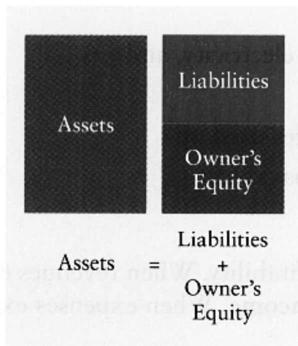
The owners' claims to the assets of the business are called **owner's equity**. These insider claims begin when an owner, such as Greg Moore, invests assets in the business and receives capital.

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.

Exhibit 1-6 diagrams how the two sides must always be equal (amounts are assumed for this illustration):

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

EXHIBIT 1-6 | **The Accounting Equation**



Owner's Equity

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

ASSETS = LIABILITIES + OWNER'S EQUITY
ASSETS = LIABILITIES + CAPITAL

- **Capital** is the amount invested in the business by its owners.
- Capital also contains the amount earned by income-producing activities and kept for use in the business. Two types of transactions that affect earnings are revenues and expenses. **Revenues** are increases in capital from delivering goods or services to customers. For example, when Moore provided music for a wedding party and earned $1,500 of revenue, the business's capital increased by $1,500.

There are relatively few types of revenue, including:

- **Sales revenue.** Greg's Groovy Tunes earns sales revenue by selling CDs to customers.
- **Service revenue.** Sherman Lawn Service earns service revenue by mowing customers' lawns.
- **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 earnings that result from operations. For example, Greg's Groovy Tunes paid wages of $1,200 to its employees and that is an expense that decreases earnings. Expenses are the opposite of revenues. They decrease capital.

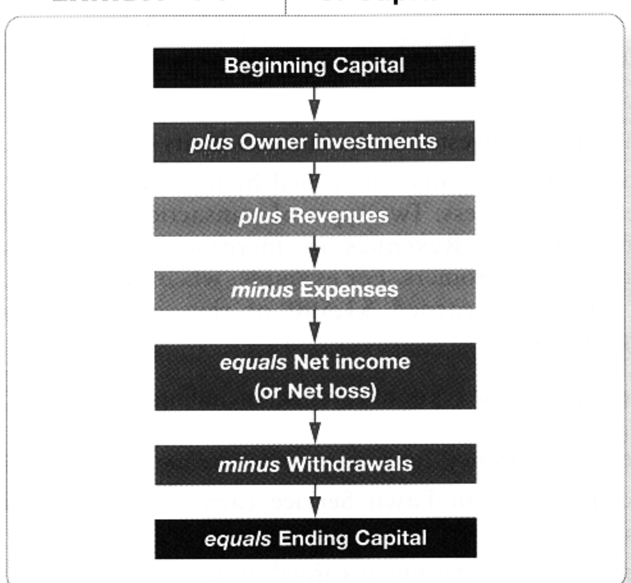
Unfortunately, businesses have lots of expenses, including

- 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 profitability. When revenues exceed expenses, the result of operations is a profit or **net income**. When expenses exceed revenues, the result is a **net loss**.

An owner can contribute more value to the business, which can increase capital. An owner may also withdraw cash (or other assets) from the business. Owner withdrawals are the fourth type of transaction that affects capital. **Withdrawals** are distributions to owners of assets (usually cash); they are not expenses. A proprietorship may or may not distribute withdrawals to the owner. Exhibit 1-7 shows the components of owner's equity (capital).

EXHIBIT 1-7 Components of Capital



The equity of corporations is different. These types of businesses separate paid-in capital from retained earnings.

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 unique reasons. However, underneath all the stated reasons is a basic desire of the student to increase his or her net worth through knowledge, higher paying job skills, or other business reasons.

Accounting for Business Transactions

8 Depict accounting for business 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. 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 Greg's Groovy Tunes does in order to manage your business affairs.

Transactions Analysis for Smart Touch Learning

To illustrate accounting for a business, let us 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. Now let us account for the transactions of Smart Touch Learning.

Transaction 1: Starting the Business

Sheena Bright starts the new business as a proprietorship named Smart Touch Learning. In April 2010 the e-learning agency receives $30,000 cash from the proprietor (owner), Sheena Bright, and gives her Capital in the business. The effect of this transaction on the accounting equation of the business is

Assets		Liabilities	+	Owner's Equity (OE)	Type of OE Transaction
Cash	=			Sheena 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 (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 proprietor/owner. This same idea applies throughout accounting.

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 Learning as follows:

	Assets			=	Liabilities +	Owner's Equity
	Cash	+	Land			Sheena 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 stationery and other office supplies that the company will use in the future, agreeing to pay $500 within 30 days. 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	+	Sheena 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 can be used in the future. The liability created by this transaction is an **Account payable.** A payable is always a liability.

Transaction 4: Earning of Service Revenue

Smart Touch Learning 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 Sheena Bright, Capital, as follows:

	Assets				Liabilities +	Owner's Equity	Type of OE Transaction
	Cash +	Office supplies +	Land		Accounts payable +	Sheena 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 (Sheena 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 performing the service (doing the work), not collecting the cash, that *earns* the revenue. As in transaction 4, increasing earnings increases Sheena 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 +	Sheena 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

	ASSETS				=	LIABILITIES +	OWNER'S EQUITY	TYPE OF OE TRANSACTION
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Sheena 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 (Sheena Bright, Capital).

Each expense should be recorded separately. The expenses are listed together 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.

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 +	Sheena Bright, Capital
Bal	12,200		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 office supplies or expenses, as Smart Touch was paying off a liability, not an expense.

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 Learning. 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

	ASSETS					LIABILITIES +	OWNER'S EQUITY
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Sheena 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. 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 +	Sheena 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 Withdrawal

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 +	Sheena Bright, Capital	
Bal	21,900	2,000	500	11,000	=	500	35,200	
(11)	−2,000						−2,000	*Owner withdrawal*
Bal	19,900	2,000	500	11,000		200	33,200	
	33,400					33,400		

The withdrawal decreases the business's Cash and owner's equity (Sheena Bright, Capital). *Withdrawals do not represent an expense because they are not related to the earning of revenue. Therefore, withdrawals 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 Explain and prepare the financial statements

We have now recorded Smart Touch Learning's transactions, and they are summarized in Exhibit 1-8. Note that every transaction maintains the equation

Assets = Liabilities + Owner's Equity

But a basic question remains: How will people actually use this information? The mass of data in Exhibit 1-8 will not tell a lender whether Smart Touch Learning 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. The **financial statements** are business documents that report on a business in monetary terms. People use the financial statements to make business decisions, such as:

- 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.
- 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 asks what the business did with any profits earned. Did the owner take out large withdrawals, or did she keep the money in the training agency? The **statement of owner's equity** answers this question.

EXHIBIT 1-8 Analysis of Transactions, Smart Touch Learning

PANEL A—Details of Transactions

1. The e-learning agency received $30,000 cash and gave capital to the owner.
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 travel service 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 $2,000.

PANEL B—Analysis of Transactions

	Assets				=	Liabilities +	Owner's Equity	Type of Owner's Equity Transaction
	Cash +	Accounts receivable +	Office supplies +	Land		Accounts payable +	Sheena Bright, Capital	
1.	+ 30,000						+ 30,000	*Owner investment*
Bal	30,000						30,000	
2.	– 20,000			+ 20,000				
Bal	10,000			20,000			30,000	
3.			+ 500			+ 500		
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	
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		

- The banker wants to know if the training 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.
- Lenders also use financial statements. Smart Touch Learning may need to raise cash for an expansion. Suppose you are considering making a loan to 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

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

The Financial Statements

After analyzing transactions, we want to see the overall results. Let us look now at the financial statements discussed in the preceding section. The financial statements summarize the transaction data into a form that is useful for decision making. As we discussed previously, the financial statements are the

- Income statement
- Statement of owner's equity
- Balance sheet
- Statement of cash flows

Headings

Each financial statement 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, and so on)
- Date or time period covered by the statement (April 30, 2010, for the balance sheet; month ended April 30, 2010, for the other statements)

An income statement (or a statement of owner's equity) that covers a year that ended in December 2010 is dated "Year Ended December 31, 2010." A monthly income statement (or statement of owner's equity) for September 2010 shows "Month Ended September 30, 2010." A quarterly income statement (or statement of owner's equity) for the three months ending June 30, 2010, shows "Quarter Ended June 30, 2010."

Income Statement

The income statement presents a summary of an entity's revenues and expenses for a period of time, such as a month, quarter, or year. The **income statement**, also called the **statement of earnings** or **statement of operations**, is like a video—a moving picture of operations during the period. The income statement holds one of the most important pieces of information about a business:

- **Net income** (total revenues greater than total expenses) or
- **Net loss** (total expenses greater than total revenues)

Net income is good news, and a net loss is bad news. What was the result of Smart Touch Learning's operations during April? Good news—the business earned net income of $5,200 (see the first overlay showing the top part of Exhibit 1-9). The income statement is very important!

Statement of Owner's Equity

The statement of owner's equity (shown in the second overlay of Exhibit 1-9) shows the changes in owner's equity during a time period, such as a month, quarter, or year.

The only increase in owner's equity comes from

- Net income (revenues exceed expenses)

Decreases in owner's equity result from two things:

- Withdrawals
- Net loss (expenses exceed revenues)

Balance Sheet

The balance sheet lists the 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. For this reason, it is also called the **statement of financial position** (see the third and fourth overlays showing the middle of Exhibit 1-9). The balance sheet is also very important!

Statement of Cash Flows

The statement of cash flows reports the cash coming in (cash receipts) and the cash going out (*cash payments*) 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 1-9.)

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

- Income statement
- Balance sheet
- Statement of owner's equity

The income statement and the balance sheet are more important than the statement of owner's equity. In Chapter 13 we cover the statement of cash flows in detail.

EXHIBIT 1-9 | **Financial Statements of Smart Touch Learning**

SMART TOUCH LEARNING
Income Statement
Month Ended April 30, 2010

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

1

SMART TOUCH LEARNING
Statement of Owner's Equity
Month Ended April 30, 2010

Sheena Bright, Capital, April 1, 2010	$ 0	
Add: Investments by owner	$30,000	
Net income for the month	5,200	
	35,200	
Less: Owner withdrawals	(2,000)	
Sheena Bright, Capital, April 30, 2010	$33,200	

SMART TOUCH LEARNING
Balance Sheet
April 30, 2010

2

Assets		Liabilities	
Cash	$19,900	Accounts payable	$ 200
Accounts receivable	2,000		
Office supplies	500	**Owner's Equity**	
Land	11,000	Sheena Bright, Capital	33,200
Total assets	$33,400	Total liabilities and owner's equity	$33,400

3

SMART TOUCH LEARNING
Statement of Cash Flows*
Month Ended April 30, 2010

Cash flows from operating activities:		
Receipts:		
Collections from customers ($5,500 + $1,000)		$ 6,500
Payments:		
To suppliers ($600 + $1,100 + $400 + $300)	$ (2,400)	
To employees	(1,200)	(3,600)
Net cash provided by operating activities		2,900
Cash flows from investing activities:		
Acquisition of land	$(20,000)	
Sale of land	9,000	
Net cash used for investing activities		(11,000)
Cash flows from financing activities:		
Investments by owner	$ 30,000	
Owner withdrawals	(2,000)	
Net cash provided by financing activities		28,000
Net increase in cash		19,900
Cash balance, April 1, 2010		0
Cash balance, April 30, 2010		$19,900

*Chapter 13 shows how to prepare this statement.

Using Financial Statements to Evaluate Business Performance

Relationships Among the Financial Statements

10 Use financial statements to evaluate business performance

Exhibit 1-9 illustrates all four financial statements. The data come from the transaction analysis in Exhibit 1-8 that covers the month of April 2010. Study the exhibit carefully. Then, observe the following in Exhibit 1-9:

1. The *income statement* for the month ended April 30, 2010
   a. Reports April's revenues and expenses.
   b. Lists expenses in decreasing order of their amount, with the largest expense first.
   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, 2010
   a. Opens with the capital balance at the beginning of the period (zero for a new entity).
   b. Adds *net income* directly from the income statement (see arrow 1 in Exhibit 1-9).
   c. Subtracts *owner withdrawals* (and net loss, if applicable). Parentheses indicate a subtraction.
   d. Ends with the capital balance at the end of the period.
3. The *balance sheet* at April 30, 2010
   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.
   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, 2010
   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, 2010. This is the amount of cash to report on the balance sheet (see arrow 3).

Each of the statements identified in Exhibit 1-9 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 reinvested in the company. Recall from Exhibit 1-9 that two main items appear in this statement that explains the change in the capital balance:

1. Net income or net loss
2. Owner withdrawals

If the owner withdrawals were larger than income for the period, this could signal concern to financial statement users. The balance sheet in Exhibit 1-9 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.

Decision Guidelines

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*.
• 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 and can be measured reliably.
• How much to record for assets and liabilities?	Actual historical amount (*cost principle*).
• 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** **+ Net income (or – Net loss)** **– Withdrawals** **= Ending Capital**
• Where does the business stand financially?	Balance sheet (accounting equation): **Assets = Liabilities + Owner's Equity**

Summary Problem

Ron Smith opens an apartment-locator business near a college campus. The business will be named Campus Apartment Locators. During the first month of operations, July 2010, 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. **Owner withdrawal of \$1,200.**

Requirements

1. Analyze the preceding transactions in terms of their effects on the accounting equation of Campus Apartment Locators. Use Exhibit 1-8 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 1-9 as a guide.

Solution

Requirement 1

Analysis of transactions

	Assets				Liabilities +	Owner's Equity	Type of OE Transaction
	Cash +	Office supplies +	Land		Accounts payable +	Ron 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, 2010

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, 2010

Ron Smith, Capital, July 1, 2010	$ 0
Add: Owner investment	$35,000
Net income for the month	1,400
	36,400
Less: Owner withdrawals	(1,200)
Ron Smith, Capital, July 31, 2010	$35,200

CAMPUS APARTMENT LOCATORS
Balance Sheet
July 31, 2010

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

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)
A promise to receive cash 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. 10)
The basic tool of accounting, measuring the resources of the business and the claims to those resources: Assets = Liabilities + Owner's Equity.

Asset (p. 5)
An economic resource that is expected to be of benefit in the future.

Audit (p. 4)
An examination of a company's financial situation.

Balance Sheet (p. 28)
An entity's assets, liabilities, and owner's equity as of a specific date. Also called the **statement of financial position**.

Capital (p. 11)
Representation of ownership investment by an owner of a proprietorship.

Certified Management Accountant (CMA) (p. 4)
A licensed 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.

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. 9)
A principle that states that acquired assets and services should be recorded at their actual cost.

Creditor (p. 3)
Someone to whom a business owes money.

Entity (p. 9)
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. 10)
The claim of a proprietorship's owner to the assets of the business. Also called **owner s equity**.

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

Financial Accounting (p. 3)
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. 18)
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**.

Liabilities (p. 10)
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.

Management Accounting (p. 3)
The branch of accounting that focuses on information for internal decision makers of a business.

Mutual Agency (p. 8)
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.

Objectivity Principle (p. 9)
Principle that asserts that data are verifiable and objective. Also called the **reliability principle**.

Owner's Equity (p. 10)
The claim of an owner to the assets of the business.

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

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

Reliability Principle (p. 9)
Principle that asserts that data are verifiable and objective. Also called the **objectivity principle**.

Revenue (p. 11)
Amounts earned by delivering goods or services to customers. Revenues increase retained earnings.

Shareholder (p. 6)
A person who owns stock in a corporation.

Stable Monetary Unit Concept (p. 10)
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. 18)
Summary of the changes in an owner's capital account during a specific period.

Stock (p. 7)
A document indicating ownership of 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. 12)
The claim of a corporation's owners to the assets of the business. Also called **owner's equity** or **shareholders' equity**.

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

Quick Check

1. Generally accepted accounting principles (GAAP) are formulated by the
   a. Securities and Exchange Commission (SEC)
   b. Institute of Management Accountants (IMA)
   c. Financial Accounting Standards Board (FASB)
   d. American Institute of Certified Public Accountants (AICPA)
2. Which type of business organization is owned by its stockholders?
   a. Corporation
   b. Partnership
   c. Proprietorship
   d. All the above are owned by stockholders
3. Which accounting concept or principle specifically states that we should record transactions at amounts that can be verified?
   a. Going-concern concept
   b. Entity concept
   c. Cost principle
   d. Reliability principle
4. **Fossil** is famous for fashion wristwatches and leather goods. At the end of a recent year, **Fossil's** total assets added up to $345 million, and owner's equity was $240 million. How much were **Fossil's** liabilities?
   a. Cannot determine from the data given
   b. $345 million
   c. $105 million
   d. $240 million

5. Assume that **Fossil** sold watches to a department store on account for $43,000. How would this transaction affect **Fossil's** accounting equation?
   a. Increase both liabilities and equity by $43,000
   b. Increase both assets and liabilities by $43,000
   c. Increase both assets and equity by $43,000
   d. No effect on the accounting equation because the effects cancel out
6. Which parts of the accounting equation does a sale on account affect?
   a. Accounts receivable and Accounts payable
   b. Accounts receivable and Capital
   c. Accounts payable and Capital
   d. Accounts payable and Cash
7. Assume that **Fossil** paid expenses totaling $40,000. How does this transaction affect **Fossil's** accounting equation?
   a. Increases assets and decreases liabilities
   b. Decreases assets and increases liabilities
   c. Decreases both assets and equity
   d. Increases both assets and equity
8. Consider the overall effects on **Fossil** of selling watches on account for $53,000 and paying expenses totaling $37,000. What is **Fossil's** net income or net loss?
   a. Net loss of $16,000
   b. Net income of $16,000
   c. Net income of $53,000
   d. Cannot determine from the data given
9. The balance sheet reports
   a. Results of operations for a specific period
   b. Financial position on a specific date
   c. Results of operations on a specific date
   d. Financial position for a specific period
10. The income statement reports
   a. Financial position on a specific date
   b. Results of operations on a specific date
   c. Results of operations for a specific period
   d. Financial position for a specific period

Answers are given after Apply Your Knowledge (p. 53).

Assess Your Progress

Short Exercises

S1-1 *(L. OBJ. 1)* **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.

Requirement

1. What are *revenues* and *expenses*?

S1-2 *(L. OBJ. 2)* **Users of financial information [5 min]**
Suppose you need a bank loan in order to purchase music equipment for Greg's Groovy Tunes, which you manage. In evaluating your loan request, the banker asks about the assets and liabilities of your 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 *(L. OBJ. 3)* **Organizations that govern CPAs [5–10 min]**
Suppose you are starting a business, T-Shirts Plus, 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 T-Shirts Plus.

S1-4 *(L. OBJ. 4)* **Types of business organizations [5–10 min]**
Claire Hunter plans on opening Claire Hunter Floral Designs. She is considering the various types of business organizations and wishes to organize her business with unlimited life and limited liability features.

Requirement

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

S1-5 *(L. OBJ. 5)* **Organizing a proprietorship [5–10 min]**
You begin A-1 Cell Service by investing $2,000 of your own money in a business bank account. You receive capital for your investment. Then the business borrows $1,000 cash by signing a note payable to Summit Bank.

Requirement

1. Listed below are the steps that you must take to organize the business and run it. Place the steps in their proper order:
   a. The bank approves your loan.
   b. You deposit a personal check for $2,000 into the account for A-1 Cell Service.
   c. You contact the bank and set up a checking account for your new business called A-1 Cell Service.
   d. Representing A-1 Cell Service, you apply for a loan from the bank.

S1-6 *(L. OBJ. 6)* **Applying accounting concepts and principles [5–10 min]**
Wendy Craven is the sole proprietor of a property management company near the campus of Pensacola Junior College. The business has cash of $6,000 and furniture that cost $12,000 and has a market value of $16,000. Debts include accounts payable of $5,000. Wendy's personal home is valued at $350,000 and her personal bank account has $9,000.

Requirements

1. Consider the accounting principles discussed in the chapter and define the principle that best matches the situation:
   a. Wendy's personal assets are not recorded on the property management company's balance sheet.
   b. Wendy records furniture at its cost of $12,000, not its market value of $16,000.
   c. Wendy does not make adjustments for inflation.
   d. The account payable of $5,000 is documented by a statement from the furniture company showing the business still owes $5,000 on the furniture. Wendy's friend thinks she should only owe about $4,000. The account payable is recorded at $5,000.
2. How much equity is in the business?

S1-7 *(L. OBJ. 7)* **Using the accounting equation [5 min]**
Snail Creek Kennel earns service revenue by caring for the pets of customers. Snail Creek's main expense is the salary paid to an employee.

Requirement

1. Write the accounting equation for the transactions below:
   a. Receiving cash of $420 for service revenue earned
   b. The payment of $135 for salary expense

S1-8 *(L. OBJ. 8)* **Analyzing transactions [5 min]**
Monte Hall Gaming paid $20,000 cash to purchase land. To buy the land, the business was obligated to pay for it.

Requirement

1. Why did the business record no liability in this transaction?

S1-9 *(L. OBJ. 8)* **Analyzing transactions [5 min]**
Awesome Adventures Travel recorded revenues of $2,400 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 that was increased as a result of the transaction.

S1-10 *(L. OBJ. 8)* **Analyzing transactions [5 min]**
Brad Polson collected cash on account from a client for whom the business had provided delivery services one month earlier.

Requirements

1. Why did the business fail to record revenue when it collected the cash on account?
2. Write two accounting equations to show the effects of
   a. Receiving cash of $300 for service revenue earned
   b. Receiving cash of $300 from customer on account

S1-11 *(L. OBJ. 9)* **Preparing the balance sheet [10 min]**
Examine Exhibit 1-8. The exhibit summarizes the transactions of Smart Touch Learning for the month of April 2010. 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, 2010. Exhibit 1-9 shows the format of the balance sheet.

S1-12 *(L. OBJ. 9)* **Preparing the income statement [10 min]**
Party Planners Extraordinaire has just completed operations for the year ended December 31, 2011. 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	3,000	Salary expense	44,000
Service revenue	109,000	Accounts payable	7,700
Supplies expense	900	Supplies	2,400
Rent expense	14,000	Withdrawals	40,000

Requirement

1. Prepare the income statement of Party Planners Extraordinaire for the year ended December 31, 2011.

S1-13 *(L. OBJ. 10)* **Evaluating business performance [10 min]**
Consider the facts presented in S1-12 for Party Planners Extraordinaire.

Requirement

1. Review the income statement prepared in S1-12. Evaluate the results of 2011 operations for Planners Extraordinaire. Was the year good or bad?

Exercises

E1-14 *(L. OBJ. 1, 5, 6)* **Using accounting vocabulary [10–15 min]**
Match the following accounting terms with their correct definition:

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

E1-15 *(L. OBJ. 2, 3, 4, 9)* **Users of financial information; the accounting profession, types of business organizations, and preparing the financial statements [15–20 min]**
Terry Maness publishes a travel magazine. In need of cash, the business asks Metro Bank for a loan. The bank requires borrowers to submit financial statements. With little knowledge of accounting, Terry Maness, the owner, does not know how to proceed.

Requirements

1. Explain how to prepare the balance sheet and the income statement.
2. Which organization is the self-regulating 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 Terry Maness?

E1-16 *(L. OBJ. 5, 6, 7)* **Characteristics of a proprietorship, accounting concepts, and using the accounting equation [5–10 min]**
Select financial information for three proprietorships follows:

	Assets	Liabilities	Owner's Equity
Nice Cuts	$?	$25,000	$43,000
Love Dry Cleaners	85,000	?	54,000
Hudson Gift and Cards	102,000	49,000	?

Requirements

1. Compute the missing amount in the accounting equation for each entity.
2. List in alphabetical order the five main characteristics of a proprietorship.
3. Which accounting concept tells us that the previous three companies will cease to exist if the owners die?

E1-17 *(L. OBJ. 7, 8)* **Using the accounting equation and analyzing business transactions [5–10 min]**

Bell Computers' balance sheet data at May 31, 2010, and June 30, 2010, follow:

	May 31, 2010	June 30, 2010
Total assets	$174,000	$208,000
Total liabilities	104,000	127,000

Requirement

1. Following are three situations about owner's investments and withdrawals from the business during June. For each situation, compute the amount of net income or net loss during June 2010.

   a. The owner invested $5,000 and made no withdrawals.
   b. The owner invested nothing and made $14,000 of withdrawals.
   c. The owner invested $15,000 and made $28,000 of withdrawals.

E1-18 *(L. OBJ. 7, 8)* **Using the accounting equation to analyze transactions [5–10 min]**

As the manager of an Aunty Pasta 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.

E1-19 *(L. OBJ. 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 Flickster Video store. Transaction (a) is answered as a guide.

   a. Received cash of $10,000 and the owner received capital.
   Answer: Increase asset (Cash)
   Increase owner's equity (Capital)
   b. Earned video rental revenue on account, $1,200.
   c. Purchased office furniture on account, $600.
   d. Received cash on account, $300.
   e. Paid cash on account, $200.
   f. Sold land for $12,000, which was the cost of the land.
   g. Rented videos and received cash of $600.
   h. Paid monthly office rent of $800.
   i. Paid $100 cash to purchase supplies that will be used in the future.

E1-20 *(L. OBJ. 7, 8)* **Using the accounting equation to analyze transactions [10–20 min]**

Cindy Surrette opened a medical practice. During July, the first month of operation, the business, titled Cindy Surrette, M.D., experienced the following events:

Jul	6	Surrette invested $53,000 in the business by opening a bank account in the name of Cindy Surrette, M.D. The business gave her capital.
	9	Paid $35,000 cash for land.
	12	Purchased medical supplies for $1,900 on account.
	15	Officially opened for business.
	15–31	During the rest of the month, Surrette treated patients and earned service revenue of $7,000, receiving cash.
	29	Paid cash expenses: employees' salaries, $2,190; office rent, $1,000; utilities, $300.
	30	Returned supplies purchased on the 12th for the cost of those supplies, $600.
	31	Paid $1,500 on account.

Requirement

1. Analyze the effects of these events on the accounting equation of the medical practice of Cindy Surrette, M.D. Use a format similar to that of Exhibit 1-8, with headings for Cash, Medical supplies, Land, Accounts payable, and Cindy Surette, Capital.

E1-21 *(L. OBJ. 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 Printman Copy & Print Service follows. The owner made only one investment and there were no owner withdrawals.

	Cash	+	Accounts receivable	+	Equipment	=	Accounts payable	+	Joe Printman, Capital
1	+ 23,000								+ 23,000
2			+ 3,400						+ 3,400
3					+ 12,700		+ 12,700		
4	+ 150		– 150						
5	– 500				+ 500				
6	– 7,600						– 7,600		
7	+ 900								+900
8	– 2,100								– 2,100

Requirements

1. Describe each transaction.
2. If these transactions fully describe the operations of Printman Copy & Print Service during the month, what was the amount of net income or net loss?

E1-22 *(L. OBJ. 7, 10)* **Using the accounting equation and evaluating business performance [10 min]**

Eager Beaver started 2011 with total assets of $24,000 and total liabilities of $11,000. At the end of 2011, the business's total assets stood at $34,000, and its total liabilities were $17,000.

Requirements

1. Did the owner's equity of Eager Beaver increase or decrease during 2011? By how much?
2. Identify two possible reasons for the change in owner's equity during the year.

E1-23 *(L. OBJ. 7, 9, 10)* **Using the accounting equation, preparing financial statements, and evaluating business performance [10–15 min]**

The 2011 annual report of Priority Parcel Service (PPS) reported revenue of $28 billion. Total expenses for the year were $21 billion. PPS ended the year with total assets of $37 billion, and it owed debts totaling $17 billion. At year-end 2010, the business reported total assets of $30 billion and total liabilities of $17 billion.

Requirements

1. Compute PPS's net income for 2011.
2. Did PPS's owner's equity increase or decrease during 2011? By how much?
3. How would you rate PPS's performance for 2011—good or bad? Give your reason. (Challenge)

E1-24 *(L. OBJ. 7, 9, 10)* **Using the accounting equation, preparing financial statements, and evaluating business performance [30–40 min]**

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

Beginning:		**Owner's Equity:**	
Assets	$48,000	Owner investments	$ 0
Liabilities	22,000	Owner withdrawals	14,000
Ending:		**Income Statement:**	
Assets	$60,000	Revenues	$231,000
Liabilities	27,000	Expenses	?

Requirements

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

E1-25 *(L. OBJ. 8)* **Analyzing business transactions [10–15 min]**

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

a. Jake's Roasted Peanuts gave capital after receiving cash from the sole proprietor.
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. Owner withdrew cash.
g. Received cash from a customer on account receivable.
h. Borrowed money from the bank.

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.

E1-26 *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [10–20 min]**

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

Equipment	$13,900	Service revenue	$10,600
Supplies	400	Accounts receivable	5,400
Note payable	6,300	Accounts payable	3,300
Rent expense	500	T. Tompkins, Capital	3,700
Cash	1,600	Salary expense	2,100

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?

E1-27 *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [10–15 min]**

The assets, liabilities, owner's equity, revenues, and expenses of Carter Design Studio have the following balances at December 31, 2010, the end of its first year of operation. During the year, the owner invested $17,000.

Note payable	$ 43,000	Office furniture	$ 48,000
Rent expense	20,000	Utilities expense	6,800
Cash	3,500	Accounts payable	3,100
Office supplies	5,000	Owner's equity	17,300
Salary expense	64,000	Service revenue	158,500
Salaries payable	2,100	Accounts receivable	9,000
Property tax expense	1,400	Supplies expense	4,500

Requirements

1. Prepare the income statement of Carter Design Studio for the year ended December 31, 2010. What is the result of operations for 2010?
2. What was the amount of the owner's withdrawals during the year?

Problems (Group A)

P1-28A *(L. OBJ. 1, 2, 3, 4, 5, 6)* **Accounting vocabulary, financial statement users, accounting profession, types of business organizations, business characteristics, and accounting concepts [15–20 min]**

Consider the following terms and definitions:

TERMS:	DEFINITIONS:
1. Proprietorship	A. Applies to corporations and proprietors or partners of LLPs or LLCs
2. Reliability principle	B. Holds that accounting records should continue reporting the historical cost of an asset over its useful life
3. Partnership	C. Is composed of accountants
4. Stock	D. One owner equity
5. Limited liability	E. States that data should be able to be confirmed by any independent observer
6. Limited Liability Company	F. Revenues of $55,000 and expenses of $30,000
7. Cost principle	G. Change in owners creates new entity
8. FASB	H. A corporation's unit of division of ownership
9. Net income of $25,000	I. Entity where the business, and not the proprietor, is liable for the company's debts

Requirement

1. Match the terms with their correct definitions.

P1-29A *(L. OBJ. 5, 6, 9)* **Proprietorship attributes, applying the entity concept, and preparing financial statements [20–25 min]**

Natalie Williams is a realtor. She organized her business as a proprietorship, Natalie Williams, Realtor, by investing $27,000 cash. The business gave capital to her. Consider the following facts at August 31, 2010.

a. The business owes $57,000 on a note payable for land that the business acquired for a total price of $80,000.
b. The business spent $27,000 for a Linka Banker real estate franchise, which entitles the business to represent itself as a Linka Banker office. This franchise is a business asset.
c. Williams owes $40,000 on a personal mortgage for her personal residence, which she acquired in 2010 for a total price of $130,000.
d. Williams has $6,000 in her personal bank account, and the business has $13,000 in its bank account.
e. Williams owes $3,000 on a personal charge account with Chico's.
f. The office acquired business furniture for $17,000 on August 25. Of this amount, the business owes $8,000 on account at August 31.
g. Office supplies on hand at the real estate office total $1,100.

Requirements

1. Natalie was concerned about liability exposure. Which proprietorship feature, if any, limits Natalie's personal liability?
2. Prepare the balance sheet of the real estate business of Natalie Williams, Realtor, at August 31, 2010.
3. Identify the personal items that would not be reported on the business records.

P1-30A *(L. OBJ. 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]**
Robert Ryan 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 Robert Ryan, CPA. Ryan 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	Ryan received $28,000 cash from former accounting partners.*
	5	Deposited $40,000 in a new business bank account titled Robert Ryan, CPA. The business gave capital to Ryan.
	6	Paid $500 cash for letterhead stationery for the new office.
	7	Purchased office furniture for the office. The business will pay the account payable, $9,000, within 3 months.
	10	Ryan sold personal investment in Amazing.com stock, which he had owned for several years, receiving $56,000 cash.*
	11	Ryan deposited the $56,000 cash from sale of the Amazing.com stock in his personal bank account.*
	12	A representative of a large company telephoned Ryan and told him of the company's intention to transfer its accounting business to Ryan.
	18	Finished tax hearings on behalf of a client and submitted a bill for accounting services, $13,000. Ryan expected to collect from this client within two weeks.
	25	Paid office rent, $1,800.
	28	Withdrew $10,000 for personal use.

*Personal transaction of Ryan.

Requirements

1. Analyze the effects of the events on the accounting equation of the corporation of Robert Ryan, CPA. Use a format similar to Exhibit 1-8.
2. As of February 28, compute:
   a. Total assets
   b. Total liabilities
   c. Total owner's equity
   d. Net income or net loss for February

P1-31A *(L. OBJ. 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]**

Arlene Lavoie 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 Arlene Lavoie, Attorney. Lavoie 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.

May	1	Sold personal investment in **eBay** stock, which she had owned for several years, receiving $30,000 cash.
	2	Deposited the $30,000 cash from sales of the **eBay** stock in her personal bank account.
	3	Received $155,000 cash from former law partners.
	5	Deposited $105,000 cash in a new business bank account titled Arlene Lavoie, Attorney. The business gave her capital.
	7	Paid $600 cash for ink cartirdges for the printer.
	9	Purchased computer for the law office, agreeing to pay the account, $9,700, within 3 months.
	23	Finished court hearings on behalf of a client and submitted a bill for legal services, $14,500, on account.
	30	Paid utilities, $1,100.
	31	Lavoie withdrew $8,000.

Requirements

1. Analyze the effects of the preceding events on the accounting equation of the corporation of Arlene Lavoie, Attorney. Use a format similar to Exhibit 1-8.
2. At May 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 Arlene Lavoie's first month of operations. Were the results good or bad?

P1-32A *(L. OBJ. 7, 8)* **Using the accounting equation for transaction analysis [20–25 min]**

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

		Cash	Accounts receivable	Supplies	Land	Accounts payable	Larry Carter, Capital
Dec	1	$2,000	$7,000	$ 800	$11,000	$3,800	10,000
	4	7,000	7,000	800	11,000	3,800	15,000
	9	4,000	7,000	800	14,000	3,800	15,000
	13	4,000	7,000	1,100	14,000	4,100	15,000
	16	2,000	7,000	1,100	14,000	2,100	15,000
	19	3,400	5,600	1,100	14,000	2,100	15,000
	22	11,400	5,600	1,100	14,000	2,100	23,000
	25	10,900	5,600	1,100	14,000	1,600	23,000
	27	10,300	5,600	1,700	14,000	1,600	23,000
	30	5,200	5,600	1,700	14,000	1,600	24,900

Requirement

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

P1-33A *(L. OBJ. 7, 8, 9, 10)* **Using the accounting equation for transaction analysis, preparing financial statements, and evaluating business performance [60–75 min]**

Marilyn Mansion owns and operates a public relations firm called Goth. The following amounts summarize her business on August 31, 2011:

		Assets			=	Liabilities	+	Owner's equity
Date	Cash	+ Accounts receivable	+ Supplies	+ Land	=	Accounts payable	+	Marilyn Mansion, Capital
Bal	2,500	1,500	0	13,000		4,000		13,000

During September 2011, the business completed the following transactions:

a. Owner invested cash of $10,000.
b. Performed service for a client and received cash of $1,100.
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, $600.
f. Received cash of $1,700 from owner.
g. Consulted for a new band and billed the client for services rendered, $4,300.
h. Recorded the following business expenses for the month:
   1. Paid office rent, $1,000.
   2. Paid advertising, $300.
i. Returned supplies to **OfficeMax** for $100 cash, which was the cost of the supplies.
j. Owner withdrew $2,200.

Requirements

1. Analyze the effects of the preceding transactions on the accounting equation of Goth. Adapt the format to that of Exhibit 1-8.
2. Prepare the income statement of Goth for the month ended September 30, 2011.
3. Prepare the entity's statement of owner's equity for the month ended September 30, 2011.
4. Prepare the balance sheet at September 30, 2011.

P1-34A *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [20–30 min]**

Presented here are the accounts of Town and Country Realty for the year ended December 31, 2011.

Land	$ 6,000		
Note payable	26,000	Accounts payable	13,000
Property tax expense	2,400	Accounts receivable	4,800
Withdrawals	26,000	Advertising expense	14,000
Rent expense	18,000	Building	133,900
Salary expense	68,000	Cash	8,000
Salary payable	1,400	Equipment	20,000
Service revenue	195,000	Insurance expense	2,300
Supplies	6,000	Interest expense	9,000
Heidi Gentry, Capital 12/31/2010	83,000		

Requirements

1. Prepare Town and Country Realty'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?
   d. What is the dollar amount of the owner's equity in the business at the end of the year?

P1-35A *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [20–30 min]**

Picture Gallery works weddings and prom-type parties. The balance of capital was $18,000 at December 31, 2010. At December 31, 2011, the business's accounting records show these balances:

Insurance expense	$ 9,000	Accounts receivable	$ 11,000
Cash	15,000	Note payable	15,000
Accounts payable	9,000	Net income	?
Advertising expense	4,000	Salary expense	20,000
Service revenue	72,000	Equipment	70,000
Owner withdrawals	16,000	Owner investments	31,000

Requirements

1. Prepare the following financial statements for Picture Gallery for the year ended December 31, 2011:
   a. Income statement
   b. Statement of owner's equity
   c. Balance sheet

P1-36A *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [20–30 min]**

The bookkeeper of Beautiful World 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.

BEAUTIFUL WORLD LANDSCAPING
Balance Sheet
Month Ended August 31, 2007

Assets		Liabilities	
Cash	$ 5,100	Accounts receivable	$ 2,400
Office supplies	700	Investments by Lori	8,000
Land	36,100	Service revenue	39,400
Salary expense	3,900	Property tax expense	1,700
Office furniture	5,900	Accounts payable	2,000
Note payable	23,300		
Rent expense	600	**Owner's Equity**	
		Lori Lindros, Capital	22,100
Total assets	$ 75,600	Total liabilities	$ 75,600

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)

P1-37B *(L. OBJ. 1, 2, 3, 4, 5, 6)* **Accounting vocabulary, financial statement users, accounting profession, types of business organizations, business characteristics, and accounting concepts [15–20 min]**

Consider the following terms and definitions:

TERMS:	DEFINITIONS:
1. Proprietorship	A. One of the chief advantages of a corporation.
2. Reliability principle	B. Holds that accounting records should continue reporting the historical cost of an asset over its useful life
3. Partnership	
4. Stock	C. Stands for Financial Accounting Standards Board
5. Limited liability	D. For this entity, from a legal perspective, the business is the proprietor
6. Limited Liability Company	E. Also called the objectivity principle
7. Cost principle	F. Revenues of $80,000 and expenses of $105,000
8. FASB	G. Joins two or more individuals as co-owners
9. Net loss of $25,000	H. A corporation's unit of division of ownership
	I. Owners are referred to as members

Requirement

1. Match the terms with their correct definitions.

P1-38B *(L. OBJ. 5, 6, 9)* **Proprietorship attributes, applying the entity concept, and preparing financial statements [20–25 min]**

Beth Plum is a realtor. She organized her business as a proprietorship, Beth Plum, Realtor, by investing $23,000 cash. The business gave capital to her. Consider the following facts at November 30, 2010:

a. The business owes $61,000 on a note payable for land that the business acquired for a total price of $85,000.
b. The business spent $30,000 for a Cinko Banker real estate franchise, which entitles the business to represent itself as a Cinko Banker office. This franchise is a business asset.
c. Plum owes $50,000 on a personal mortgage for her personal residence, which she acquired in 2010 for a total price of $170,000.
d. Plum has $5,000 in her personal bank account, and the business has $10,000 in its bank account.
e. Plum owes $1,000 on a personal charge account with Chico's.
f. The office acquired business furniture for $15,000 on November 25. Of this amount, the business owes $1,000 on account at November 30.
g. Office supplies on hand at the real estate office total $500.

Requirements

1. Beth was concerned about liability exposure. Which proprietorship feature, if any, limits Beth's personal liability?
2. Prepare the balance sheet of the real estate business of Beth Plum, Realtor, at November 30, 2010.
3. Identify the personal items that would not be reported on the business records.

P1-39B *(L. OBJ. 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]**

Arthur 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 Arthur 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 $26,000 cash from former accounting partners.*
	5	Deposited $70,000 in a new business bank account titled Arthur Shore, CPA. The business gave capital to Shore.
	6	Paid $700 cash for letterhead stationery for the new office.
	7	Purchased office furniture for the office. The business will pay the account payable, $9,900, within 3 months.
	10	Shore sold personal investment in Amazing.com stock, which he had owned for several years, receiving $54,000 cash.*
	11	Shore deposited the $54,000 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, $16,000. Shore expected to collect from this client within two weeks.
	25	Paid office rent, $1,000.
	28	Owner withdrew $1,000.

*Personal transaction of Arthur Shore.

Requirements

1. Analyze the effects of the events on the accounting equation of the corporation of Arthur Shore, CPA. Use a format similar to Exhibit 1-8.
2. As of February 28, compute the following:
   a. Total assets
   b. Total liabilities
   c. Total owner's equity
   d. Net income or net loss for February

P1-40B *(L. OBJ. 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]**

Anna Judge 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 Anna Judge, Attorney. Judge 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.

Jul	1	Sold personal investment in **eBay** stock, which she had owned for several years, receiving $34,000 cash.
	2	Deposited the $34,000 cash from sales of the **eBay** stock in her personal bank account.
	3	Received $133,000 cash from former law partners.
	5	Deposited $83,000 cash in a new business bank account titled Anna Judge, Attorney. The business gave capital to Judge.
	7	Paid $800 cash for ink cartirdges for the printer.
	9	Purchased a computer for the law office, agreeing to pay the account, $9,000, within 3 months.
	23	Finished court hearings on behalf of a client and submitted a bill for legal services, $13,000, on account.
	30	Paid utilities, $1,700.
	31	Owner withdrew $9,000.

Requirements

1. Analyze the effects of the preceding events on the accounting equation of the corporation of Anna Judge, Attorney. Use a format similar to Exhibit 1-8.
2. At July 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 Anna Judge's first month of operations. Were the results good or bad?

P1-41B *(L. OBJ. 7, 8,)* **Using the accounting equation for transaction analysis [20–25 min]**

Pelligrini Electronics 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	Philip Johnson, Capital
Nov 1	$2,000	$7,000	$ 800	$11,000	$3,800	10,000
4	6,000	7,000	800	11,000	3,800	14,000
9	3,000	7,000	800	14,000	3,800	14,000
13	3,000	7,000	900	14,000	3,900	14,000
16	1,400	7,000	900	14,000	2,300	14,000
19	2,500	5,900	900	14,000	2,300	14,000
22	10,500	5,900	900	14,000	2,300	22,000
25	10,000	5,900	900	14,000	1,800	22,000
27	9,300	5,900	1,600	14,000	1,800	22,000
30	3,400	5,900	1,600	14,000	1,800	23,100

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.

P1-42B *(L. OBJ. 7, 8, 9, 10)* **Using the accounting equation for transaction analysis, preparing financial statements, and evaluating business performance [60–75 min]**

Marian Crone owns and operates a public relations firm called Dance Fever. The following amounts summarize her business on August 31, 2011:

	Assets							=	Liabilities	+	Equity
Date	Cash	+	Accounts receivable	+	Supplies	+	Land	=	Accounts payable	+	Marian Crone, Capital
Bal	2,400	+	1,800	+	0	+	14,000	=	3,000	+	15,200

During September 2011, the business completed the following transactions:

a. Owner invested cash of $15,000.
b. Performed service for a client and received cash of $1,200.
c. Paid off the beginning balance of accounts payable.
d. Purchased supplies from **OfficeMax** on account, $500.
e. Collected cash from a customer on account, $600.
f. Received cash of $2,000 from owner.
g. Consulted for a new band and billed the client for services rendered, $5,300.
h. Recorded the following business expenses for the month:
   1. Paid office rent, $1,100.
   2. Paid advertising, $500.
i. Returned supplies to **OfficeMax** for $90 cash, which was the cost of the supplies.
j. Owner withdrew $2,000.

Requirements

1. Analyze the effects of the preceding transactions on the accounting equation of Dance Fever. Adapt the format to that of Exhibit 1-8.
2. Prepare the income statement of Dance Fever for the month ended September 30, 2011.
3. Prepare the entity's statement of owner's equity for the month ended September 30, 2011.
4. Prepare the balance sheet at September 30, 2011.

P1-43B *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [20–30 min]**
Presented here are the accounts of Plantscapes Décor Services for the year ended December 31, 2011.

Land	$ 9,000		
Note payable	32,000	Accounts payable	11,000
Property tax expense	2,500	Accounts receivable	4,000
Withdrawals	28,000	Advertising expense	19,000
Rent expense	11,000	Building	128,100
Salary expense	66,000	Cash	9,000
Salary payable	800	Equipment	18,000
Service revenue	189,000	Insurance expense	2,200
Supplies	6,000	Interest expense	6,000
Tom English, Capital 12/31/2010	76,000		

Requirements

1. Prepare Plantscapes Décor Services' 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?
   d. What is the dollar amount of the owner's equity in the business at the end of the year?

P1-44B *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [20–30 min]**

Accent Photography works weddings and prom-type parties. The balance of capital was $20,000 at December 31, 2010. At December 31, 2011, the business's accounting records show these balances:

Insurance expense	$ 8,000	Accounts receivable	$ 10,000
Cash	31,000	Note payable	12,000
Accounts payable	6,000	Owner's equity	?
Advertising expense	1,000	Salary expense	27,000
Service revenue	81,000	Equipment	60,000
Owner withdrawals	15,000	Owner investment	33,000

Requirement

1. Prepare the following financial statements for Accent Photography for the year ended December 31, 2011:
   a. Income statement
   b. Statement of owner's equity
   c. Balance sheet

P1-45B *(L. OBJ. 9, 10)* **Preparing financial statements and evaluating business performance [20–30 min]**

The bookkeeper of Lone Star 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.

LONE STAR LANDSCAPING
Balance Sheet
Month Ended May 31, 2007

Assets		Liabilities	
Cash	$ 5,500	Accounts receivable	$ 2,500
Office supplies	900	Capital	12,000
Land	35,300	Service revenue	39,300
Salary expense	2,700	Property tax expense	1,600
Office furniture	6,200	Accounts payable	2,300
Note payable	22,800		
Rent expense	400	**Owner's Equity**	
		Walt Temple, Capital	16,100
Total assets	$ 73,800	Total liabilities	$ 73,800

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.
3. Did total assets as presented in your corrected balance sheet increase, decrease, or stay the same from the original balance sheet? Why?

Continuing Exercise

Exercise 1-46 is the first exercise in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 5.

E1-46 Sherman Lawn Service began operations and completed the following transactions during August:

Aug	1	Received $1,000 from owner, Hannah Sherman. Deposited this amount in bank account titled Sherman Lawn Service.
	3	Purchased on account a mower, $1,000, and weed whacker, $400. The equipment is expected to remain in service for four years.
	5	Purchased $20 of gas. Wrote check #1 from the new bank account.
	6	Performed lawn services for client on account, $200.
	8	Purchased $50 of fertilizer from the lawn store. Wrote check #2 from the new bank account.
	17	Completed landscaping job for client, received cash $500.
	31	Received $50 on account from Aug 6 sale.

Requirement

1. Analyze the effects of Sherman Lawn Service transactions on the accounting equation. Use the format of Exhibit 1-8, and include these headings: Cash, Accounts receivable, Lawn supplies, Equipment, Accounts payable, and Hannah Sherman, Capital.

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

Continuing Problem

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

P1-47 Haupt Consulting began operations and completed the following transactions during the first half of December:

Dec	2	Received $10,000 cash from owner Carl Haupt.
	2	Paid monthly office rent, $500.
	3	Paid cash for a Dell computer, $2,000. This equipment is expected to remain in service for five years.
	4	Purchased office furniture on account, $3,600. The furniture should last for five years.
	5	Purchased supplies on account, $300.
	9	Performed consulting service for a client on account, $1,700.
	12	Paid utility expenses, $200.
	18	Performed service for a client and received cash of $800.

Requirements

1. Analyze the effects of Haupt Consulting's transactions on the accounting equation. Use the format of Exhibit 1-8, and include these headings: Cash, Accounts receivable, Supplies, Equipment, Furniture, Accounts payable, and Carl Haupt, Capital.
2. Prepare the income statement of Haupt Consulting for the month ended December 31, 2010.
3. Prepare the statement of owner's equity for the month ended December 31, 2010.
4. Prepare the balance sheet at December 31, 2010.

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

Practice Set

Create an initial chart of accounts based on the following transactional data for the first month of operations of Crystal Clear Cleaning.

Apr 1: CJ Oliver deposited $20,000 in the business account. Also on this date, CJ transferred his truck title, worth $5,000, to the business. CJ received capital in return.

Apr 2: Wrote a check for $1,600 to Prestige Properties. In the "for" area of the check, it states "April thru July Rent."

Apr 3: Purchased business insurance policy for $1,200 for the term April 1, 2009, through March 31, 2010 and paid cash.

Apr 4: CJ went to the Cleaning Supply Company and purchased $220 of cleaning supplies on account. The invoice is due 20 days from the date of purchase.

Apr 5: Purchased on account an industrial vacuum cleaner from Save-Now costing $2,000. The invoice is payable on or before April 25.

Apr 7: Purchased a computer and printer costing a total of $1,500. A check for the same amount to the computer store was written on the same date.

Apr 9: Performed cleaning services on account for Bob's Burger House in the amount of $3,200.

Apr 10: Deposited Bob's check for $200 in the bank.

Apr 15: Wrote check payable to Ben Larrison for $300 for contract labor.

Apr 16: Received $1,200 for 1 year contract beginning April 1 for cleaning services to be provided to the Oar Restaurant. Contract begins April 1, 2009, and ends March 31, 2010.

Apr 17: Provided cleaning services for In Balance Solutions for $700. In Balance paid with a check.

Apr 18: Received water and electric bill for $200 with due date of May 4, 2009.

Apr 20: Borrowed $10,000 from bank with interest at rate of 8% per year.

Apr 21: Deposited check from Bob's Burger House for $1,000 paid on account.

Apr 25: Wrote check to Save Now for invoice #1035 in the amount of $1,500.

Apr 29: Wrote check payable to Pensacola News for $200 for advertising.

Apr 30: CJ Oliver withdrew $500.

Requirements

1. Create an initial list of accounts that Crystal Clear will need.
2. Prepare an analysis of the April activity using the format displayed in Exhibit 1-8 as a guide.

Apply Your Knowledge

Decision Cases

Case 1. This case follows up on the chapter-opening story about Sherman Lawn Service and Greg's Groovy Tunes. It is now the end of the first year of operations, and both owners—Hannah Sherman and Greg Moore—want to know how well they came out at the end of the year. Neither business kept complete accounting records (even though Greg Moore majored in accounting). Sherman and Moore throw together the following data at year end:

Sherman Lawn Service:	
Total assets	$12,000
Equity	8,000
Total revenues	35,000
Total expenses	22,000
Greg's Groovy Tunes:	
Total liabilities	$ 7,000
Equity	6,000
Total expenses	44,000
Net income	9,000

Working in the lawn-service business, Moore has forgotten all the accounting he learned in college. Sherman majored in environmental science, 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 Sherman and Moore that you know what you are talking about.

1. Which business has more assets?
2. Which business owes more to creditors?
3. In which business has the owner invested more?
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)

Case 2. Dave and Reba Guerrera saved all their married life to open a bed and breakfast (B&B) named Tres Amigos. Dave invested $100,000 of their own money and the company gave capital to Dave. 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. Dave and Reba 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 the business's activities thus far. Tres Amigos' bank statement shows a cash balance of $38,000. Dave and Reba feel pretty good with that much net income in only six months. 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, 2010	
Revenues:	
Investments by owner	$100,000
Bank loan	100,000
Total revenues	200,000
Expenses:	
Cost of the house	$ 80,000
Repairs 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. (Challenge)
2. Prepare Tres Amigos' balance sheet from its data.

Ethical Issues

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

Wai Lee, company president: "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? (Challenge)
2. Discuss how Wai Lee's proposals violate generally accepted accounting principles. Identify each specific concept or principle involved.

Ethical Issue 2. The tobacco companies have paid billions because of smoking-related illnesses. In particular, **Philip Morris**, a leading cigarette manufacturer, paid over $3 billion 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? (Challenge)
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? (Challenge)

Financial Statement Case

This and similar cases in later chapters focus on the financial statement of a real company—**Amazon.com**, 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, 2007?
2. What were the company's total assets at December 31, 2007? At December 31, 2006?
3. Write the company's accounting equation at December 31, 2007, by filling in the dollar amounts:

ASSETS = LIABILITIES + EQUITY

4. Identify net sales (revenue) for the year ended December 31, 2007. How much did total revenue increase or decrease from 2006 to 2007?
5. How much net income or net loss did **Amazon** earn for 2007 and for 2006? Based on net income, was 2007 better or worse than 2006?

Team Projects

Project 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 before you have had time to pay all the business's bills. 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.

Project 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 and before you have had time to pay all the business's bills and to collect all receivables. 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.

Quick Check Answers

For online homework, exercises, and problems that provide you immediate feedback, please visit www.myaccountinglab.com.

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

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.

Learning Objectives 7, 8, and 9

On March 1, 2011, David Richardson opened a painting business near an historical housing district. David was the sole owner of the company, which he named DR Painting. During March 2011, DR Painting engaged in the following transactions:

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

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. **The owner withdrew $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 1-8 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 1-9 in the text as a guide.

Demo Doc Solutions

Requirement 1

Analyze the preceding transactions in terms of their effects on the accounting equation of DR Painting. Use Exhibit 1-8 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 David.

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

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

The effect of this transaction on the accounting equation is

	ASSETS	+ LIABILITIES	=	OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	Cash	+	=	David 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 (David 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

	ASSETS			LIABILITIES +	OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	Cash	+ Truck			David Richardson, Capital	
a.	40,000		=		40,000	*Owner investment*
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* holds, 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 have *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

	ASSETS			=	LIABILITIES	+	OWNER'S EQUITY
	Cash	+ Supplies	+ Truck	=	Accounts payable	+	David 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 Bal
			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 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 (as opposed to *sales* revenues).

This means that there is an increase in Service revenue (which increases 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 Capital.

The effect of this transaction on the accounting equation is

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

Note that we write "Service revenue" to the right of the 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 when 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 (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 *receiv*able. 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

	ASSETS				= LIABILITIES	+ OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	Cash	Accounts receivable	Supplies	Truck	Accounts payable	David 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

	ASSETS				= LIABILITIES	+ OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	Cash	Accounts receivable	Supplies	Truck	Accounts payable	David 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 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

	ASSETS				= LIABILITIES +	OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	Cash	Accounts receivable	Office supplies	Truck	Accounts payable	David Richardson, Capital	
Bal	22,200	4,000	1,800	20,000	1,000		
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. The owner withdrew $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 an owner and is being given some of his value/ownership in cash. In other words, some of the *earnings* that were *retained* by the company are now being distributed to the owner. This results in a decrease of $1,500 to owner's equity, because Capital is decreasing.

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

The effect of this transaction on the accounting equation is

	ASSETS				= LIABILITIES +	OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	Cash	Accounts receivable	Office supplies	Truck	Accounts payable	David 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

	Assets				= Liabilities +	Owner's Equity	Type of Owner's Equity Transaction
	Cash	Accounts receivable	Office supplies	Truck	Accounts payable	David 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
	Cash +	Accounts receivable +	Supplies +	Truck =	Accounts payable +	David Richardson, Capital
a.	+$40,000					+$40,000
b.	−$20,000			+$20,000		
c.			+$1,800		+$1,800	
d.	+$3,000					+$3,000
e.		+$4,000				+4,000
f.	−$800				−$800	
g.	−$1,000					−$1,000
h.	−$1,500					−$1,500
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 1-9 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, 2011). 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, 2011

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 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, 2011). As with the income statement, we are reporting Owner's Equity 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 owner's equity. This calculation uses the following formula:

Beginning Capital
+ Net Income (or – Net Loss)
– Withdrawals
Ending Capital

Start the body of the statement of owner's equity with the capital at the beginning of the period (March 1). Then, list net income. You should notice that the amount of net income comes directly from the income statement. Following net income you will list the withdrawals paid, which reduces capital. Finally, total all amounts and compute the capital at the end of the period.

In this case, because this is a new company, the beginning capital is zero. Owner investments made during the month of $40,000 are added. Net income as reported on the income statement ($6,000) is added. In transaction **h**, the owner withdrew $1,500. These withdrawals are deducted. The statement of owner's equity follows:

DR PAINTING
Statement of Owner's Equity
Month Ended March 31, 2011

David Richardson, Capital, March 1, 2011	$ 0
Add: Investments by owner	40,000
Net income for the month	6,000
Less: Withdrawals	(1,500)
David Richardson, Capital, March 31, 2011	$ 44,500

Note the result is a balance of $44,500 ($40,000 + $6,000 – $1,500 = $44,500) for Ending 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 time period covered (March 31, 2011). 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 Capital comes directly from the ending Capital on your 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 value 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 work sheet. From the statement of owner's equity, we have ending 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, 2011

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

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