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Chapter 1

Accounting in Action

STUDY OBJECTIVES

After studying this chapter, you should be able to:

1 Explain what accounting is.
2 Identify the users and uses of accounting.
3 Understand why ethics is a fundamental business concept.
4 Explain generally accepted accounting principles and the cost principle.
5 Explain the monetary unit assumption and the economic entity assumption.
6 State the accounting equation, and define its components.
7 Analyze the effects of business transactions on the accounting equation.
8 Understand the four financial statements and how they are prepared.

The Navigator

Study Objectives give you a framework for learning the specific concepts covered in the chapter.

The Navigator

Scan **Study Objectives**

Read **Feature Story**

Read **Preview**

Read text and answer **DO IT!**
p. 10 p. 13 p. 19 p. 24

Work **Comprehensive DO IT!**

Review **Summary of Study Objectives**

Answer **Self-Study Questions**

Complete **Assignments**

The Navigator is a learning system designed to prompt you to use the learning aids in the chapter and set priorities as you study.

Feature Story

KNOWING THE NUMBERS

Consider this quote from Harold Geneen, the former chairman of IT&T: "To be good at your business, you have to know the numbers—cold." Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting and financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

When Jack Stack and 11 other managers purchased Springfield ReManufacturing Corporation (SRC) (*www.srcreman.com*) for 10 cents a share, it was a failing

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division of International Harvester. Stack had 119 employees who were counting on him for their livelihood, and he knew that the company was on the verge of financial failure.

Stack decided that the company's only chance of survival was to encourage every employee to think like a businessperson and to act like an owner. To accomplish this, all employees at SRC took basic accounting courses and participated in weekly reviews of the company's financial statements. SRC survived, and eventually thrived. To this day, every employee (now numbering more than 1,000) undergoes this same training.

Many other companies have adopted this approach, which is called "open-book management." Even in companies that do not practice open-book management, employers generally assume that managers in all areas of the company are "financially literate."

Taking this course will go a long way to making you financially literate. In this book you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. Appendixes A and B provide real financial statements of two well-known companies, PepsiCo, Inc. and The Coca-Cola Company. Throughout this textbook we attempt to increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements.

The Feature Story helps you picture how the chapter topic relates to the real world of accounting and business. You will find references to the story throughout the chapter.

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Inside Chapter 1...

"Inside Chapter x" lists boxes in the chapter that should be of special interest to you.

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Preview of Chapter 1

The opening story about Springfield ReManufacturing Corporation highlights the importance of having good financial information to make effective business decisions. Whatever one's pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision making depends on good information.

The purpose of this chapter is to show you that accounting is the system used to provide useful financial information. The content and organization of Chapter 1 are as follows.

Accounting in Action

- **What Is Accounting?**
  - Three activities
  - Who uses accounting data
- **The Building Blocks of Accounting**
  - Ethics in financial reporting
  - Generally accepted accounting principles
  - Assumptions
- **The Basic Accounting Equation**
  - Assets
  - Liabilities
  - Owner's equity
- **Using the Accounting Equation**
  - Transaction analysis
  - Summary of transactions
- **Financial Statements**
  - Income statement
  - Owner's equity statement
  - Balance sheet
  - Statement of cash flows

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*The **Preview** describes and outlines the major topics and subtopics you will see in the chapter.*

WHAT IS ACCOUNTING?

STUDY OBJECTIVE 1
Explain what accounting is.

Why is accounting so popular? What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by Nike founder Phil Knight, Home Depot co-founder Arthur Blank, former acting director of the Federal Bureau of Investigation (FBI) Thomas Pickard, and numerous members of Congress? Accounting.[1] Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

Three Activities

To **identify** economic events, a company selects the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by PepsiCo, providing of telephone services by AT&T, and payment of wages by Ford Motor Company.

[1] The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

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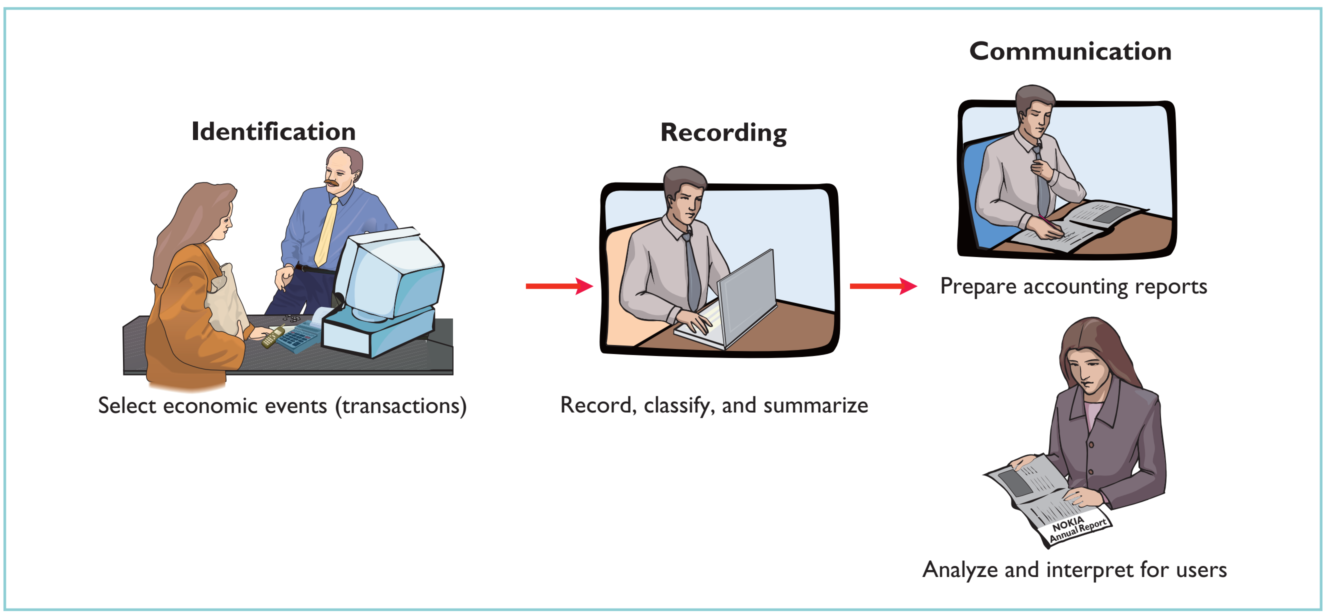
Once a company like PepsiCo identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic**, **chronological diary of events**, measured in dollars and cents. In recording, PepsiCo also classifies and summarizes economic events.

Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, Kellogg reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, PepsiCo accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses**, **meaning**, **and limitations of reported data**. Appendix A of this textbook shows the financial statements of PepsiCo, Inc.; Appendix B illustrates the financial statements of The Coca-Cola Company. We refer to these statements at various places throughout the text. At this point, they probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1-1 summarizes the activities of the accounting process.

Illustration 1-1
The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying**, **recording**, **and communicating economic events**.[2]

Essential terms *are printed in blue when they first appear, and are defined in the end-of-chapter glossary.*

[2]The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica, Geometria, Proportione et Proportionalite,* Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

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Who Uses Accounting Data

STUDY OBJECTIVE 2

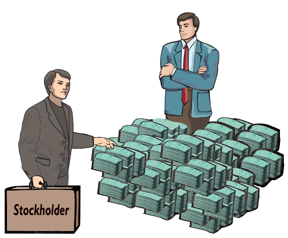
Identify the users and uses of accounting.

The information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal users and external users.

INTERNAL USERS

Internal users of accounting information are those individuals inside a company who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1-2.

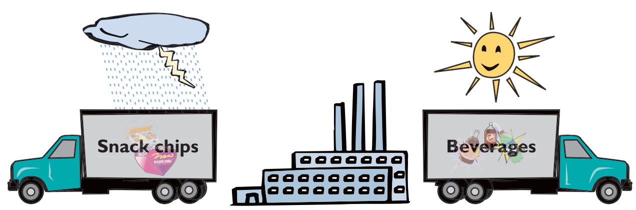
Illustration 1-2
Questions asked by internal users



Finance
Is cash sufficient to pay dividends to Microsoft stockholders?

Marketing
What price for an Apple iPod will maximize the company's net income?

Human Resources
Can we afford to give General Motors employees pay raises this year?



Management
Which PepsiCo product line is the most profitable? Should any product lines be eliminated?

To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

EXTERNAL USERS

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. Illustration 1-3 shows some questions that investors and creditors may ask.

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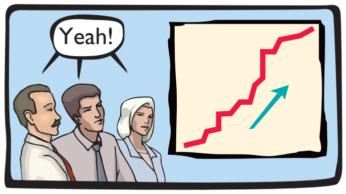
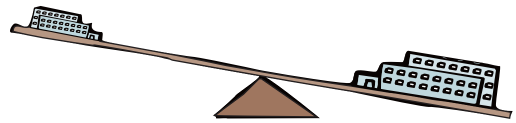


Investors
Is General Electric earning satisfactory income?



Investors
How does Disney compare in size and profitability with Time Warner?

Creditors
Will United Airlines be able to pay its debts as they come due?

Illustration 1-3
Questions asked by external users

Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities** (such as the Internal Revenue Service) want to know whether the company complies with tax laws. **Regulatory agencies**, such as the Securities and Exchange Commission and the Federal Trade Commission, want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like General Motors will continue to honor product warranties and support its product lines. **Labor unions** such as the Major League Baseball Players Association want to know whether the owners can pay increased wages and benefits.

THE BUILDING BLOCKS OF ACCOUNTING

A doctor follows certain standards in treating a patient's illness. An architect follows certain standards in designing a building. An accountant follows certain standards in reporting financial information. For these standards to work, a fundamental business concept must be at work—ethical behavior.

Ethics in Financial Reporting

STUDY OBJECTIVE 3
Understand why ethics is a fundamental business concept.

People won't gamble in a casino if they think it is rigged. Similarly, people won't play the stock market if they think stock prices are rigged. In recent years the financial press has been full of articles about financial scandals at Enron, WorldCom, HealthSouth, AIG, and others. As the scandals came to light, mistrust of financial reporting in general grew. One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling."[3] Imagine trying to carry on a business or invest money if you could

[3]"U.S. Share Prices Slump," *Wall Street Journal*, February 21, 2002.

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not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

Ethics Notes help sensitize you to some of the ethical issues in accounting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act of 2002** (SOX, or Sarbox). Its intent is to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals. As a result of SOX, top management must now certify the accuracy of financial information. In addition, top management now faces much more severe penalties for fraudulent financial activity. Also, SOX calls for increased independence of the outside auditors who review the accuracy of corporate financial statements and increased responsibility of boards of directors in their oversight role.

ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures that (like cutting the deck of playing cards) help ensure that fraud will not occur.

The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this book:

1. A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *All About You* boxes (near the chapter Summary; see page 25, for example) focus on ethical issues you may face in your college and early-career years.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision maker in that case.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in Illustration 1-4.

Illustration 1-4
Steps in analyzing ethics cases and situations

1. Recognize an ethical situation and the ethical issues involved.
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.
Identify the *stakeholders*—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

Generally Accepted Accounting Principles

STUDY OBJECTIVE 4

Explain generally accepted accounting principles and the cost principle.

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called **generally accepted accounting principles (GAAP)**. These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange**

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Commission (SEC) is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. In recent years the FASB and IASB have worked closely to try to minimize the differences in their standards and principles.

INTERNATIONAL NOTE

Over 100 countries use international standards (sometimes called iGAAP). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant. In this book, we highlight any major differences using International Notes like this one.

International Notes highlight differences between U.S. and international accounting standards.

One important accounting principle is the cost principle. The **cost principle** (or historical cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if Best Buy purchases land for $30,000, the company initially reports it in its accounting records at $30,000. But what does Best Buy do if, by the end of the next year, the land has increased in value to $40,000? Under the cost principle it continues to report the land at $30,000.

Critics contend the cost principle is misleading. They argue that market value (the value determined by the market at any particular time) is more useful to financial decision makers than is cost. Those who favor the cost principle counter that cost is the best measure. The reason: Cost can be easily verified, whereas market value is often subjective (it depends on who you ask). Recently, the FASB has changed some accounting rules and now requires that certain investment securities be recorded at their market value. In choosing between cost and market value, the FASB used two qualities that make accounting information useful for decision making—reliability and relevance: In this case, it weighed the **reliability** of cost figures versus the **relevance** of market value.

Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

STUDY OBJECTIVE 5

Explain the monetary unit assumption and the economic entity assumption.

MONETARY UNIT ASSUMPTION

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to applying the cost principle.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money.

ECONOMIC ENTITY ASSUMPTION

An economic entity can be any organization or unit in society. It may be a company (such as Crocs, Inc.), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the Boutique. Similarly, McDonald's, Coca-Cola, and Cadbury-Schweppes are segregated into separate economic entities for accounting purposes.

ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving Adelphia. In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Aldephia guaranteed over $2 billion of loans to the founding family.

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Proprietorship. A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships. **Usually only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership. A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved. Typically a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner. Each partner generally has unlimited personal liability for the debts of the partnership. **Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.** Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants).

Corporation. A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is a **corporation**. The holders of the shares (stockholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Stockholders **may transfer all or part of their ownership shares to other investors at any time** (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation. Because ownership can be transferred without dissolving the corporation, the corporation **enjoys an unlimited life**.

Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest enterprises in the United States—for example, ExxonMobil, General Motors, Wal-Mart, Citigroup, and Microsoft—are corporations.

*The **Do It** exercises ask you to put newly acquired knowledge to work. They outline the Action Plan necessary to complete the exercise, and they show a Solution.*

DO IT!

BASIC CONCEPTS

Indicate whether each of the five statements presented below is true or false.

1. The three steps in the accounting process are identification, recording, and communication.
2. The two most common types of external users are investors and company officers.
3. Congress passed the Sarbanes-Oxley Act of 2002 to reduce unethical behavior and decrease the likelihood of future corporate scandals.
4. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
5. The cost principle dictates that companies record assets at their cost. In later periods, however, the market value of the asset must be used if market value is higher than its cost.

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Solution

1. True 2. False. The two most common types of external users are investors and creditors. 3. True. 4. True. 5. False. The cost principle dictates that companies record assets at their cost. Under the cost principle, the company must also use cost in later periods as well.

action plan

✔ Review the basic concepts learned to date.

✔ Develop an understanding of the key terms used.

Related exercise material: **E1-1, E1-2, E1-3, E1-4,** and **DO IT! 1-1.**

The Navigator

ACCOUNTING ACROSS THE ORGANIZATION

How Will Accounting Help Me?

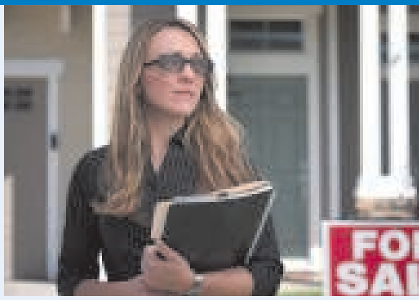
One question that students frequently ask is, "How will the study of accounting help me?" It should help you a great deal, because a working knowledge of accounting is desirable for virtually *every field* of endeavor. Some examples of how accounting is used in other careers include:

General management: Imagine running Ford Motors, Massachusetts General Hospital, Northern Virginia Community College, a Subway franchise, a Trek bike shop. All general managers need to understand where the enterprise's cash comes from and where it goes in order to make wise business decisions.

Marketing: A marketing specialist at a company like Procter & Gamble develops strategies to help the sales force be successful. But making a sale is meaningless unless it is a profitable sale. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

Finance: Do you want to be a banker for Bank of America, an investment analyst for Goldman Sachs, a stock broker for Merrill Lynch? These fields rely heavily on accounting. In all of them you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for Prudential Real Estate? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?



Accounting Across the Organization *boxes demonstrate applications of accounting information in various business functions.*

? How might accounting help you?

THE BASIC ACCOUNTING EQUATION

STUDY OBJECTIVE 6

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, Google has total assets of approximately $18.4 billion. Liabilities and owner's equity are the rights or claims against these resources. Thus, Google has $18.4 billion of claims against its $18.4 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **owner's equity**. Google has liabilities of $1.4 billion and owners' equity of $17 billion.

We can express the relationship of assets, liabilities, and owner's equity as an equation, as shown in Illustration 1-5 (page 12).

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Illustration 1-5
The basic accounting equation

Assets	=	Liabilities	+	Owner's Equity

This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and owner's equity. Liabilities appear before owner's equity in the basic accounting equation because they are paid first if a business is liquidated.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as PepsiCo. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

Assets

As noted above, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, Campus Pizza owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza are tables, chairs, jukebox, cash register, oven, tableware, and, of course, cash.

Liabilities

Liabilities are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Campus Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.
- Campus Pizza also has a **note payable** to First National Bank for the money borrowed to purchase the delivery truck.
- Campus Pizza may also have **wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Campus Pizza owes money are its **creditors**.

Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

Owner's Equity

The ownership claim on total assets is **owner's equity**. It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or owners. To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets. The remainder is the owner's claim on the assets—the owner's equity. Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

INCREASES IN OWNER'S EQUITY

In a proprietorship, owner's investments and revenues increase owner's equity.

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Investments by Owner. **Investments by owner** are the assets the owner puts into the business. These investments increase owner's equity. They are recorded in a category called **owner's capital**.

Revenues. **Revenues** are the **gross increase in owner's equity resulting from business activities entered into for the purpose of earning income**. Generally, revenues result from selling merchandise, performing services, renting property, and lending money. Common sources of revenue are sales, fees, services, commissions, interest, dividends, royalties, and rent.

Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Campus Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales.

HELPFUL HINT

In some places we use the term "owner's equity" and in others we use "owners' equity." *Owner's* (singular, possessive) refers to one owner (the case with a sole proprietorship). *Owners'* (plural, possessive) refers to multiple owners (the case with partnerships or corporations).

DECREASES IN OWNER'S EQUITY

In a proprietorship, owner's drawings and expenses decrease owner's equity.

Drawings. An owner may withdraw cash or other assets for personal use. We use a separate classification called **drawings** to determine the total withdrawals for each accounting period. **Drawings decrease owner's equity.**

Expenses. **Expenses** are the cost of assets consumed or services used in the process of earning revenue. They are **decreases in owner's equity that result from operating the business**. For example, Campus Pizza recognizes the following expenses: cost of ingredients (meat, flour, cheese, tomato paste, mushrooms, etc.); cost of beverages; wages expense; utility expense (electric, gas, and water expense); telephone expense; delivery expense (gasoline, repairs, licenses, etc.); supplies expense (napkins, detergents, aprons, etc.); rent expense; interest expense; and property tax expense.

In summary, owner's equity is increased by an owner's investments and by revenues from business operations. Owner's equity is decreased by an owner's withdrawals of assets and by expenses. Illustration 1-6 expands the basic accounting equation by showing the accounts that comprise owner's equity. This format is referred to as the **expanded accounting equation**.

Basic Equation:	Assets = Liabilities	+	Owner's Equity
Expanded Equation:	Assets = Liabilities	+	Owner's Capital − Owner's Drawings + Revenues − Expenses

Illustration 1-6
Expanded accounting equation

DO IT!

Classify the following items as investment by owner (I), owner's drawings (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases owner's equity.

(1) Rent Expense (3) Drawings

(2) Service Revenue (4) Salaries Expense

OWNER'S EQUITY EFFECTS

action plan

✔ Understand the sources of revenue.

✔ Understand what causes expenses.

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action plan (cont'd)

- ✔ Review the rules for changes in owner's equity: Investments and revenues increase owner's equity. Expenses and drawings decrease owner's equity.
- ✔ Recognize that drawings are withdrawals of cash or other assets from the business for personal use.

Solution

1. Rent Expense is an expense (E); it decreases owner's equity. 2. Service Revenue is revenue (R); it increases owner's equity. 3. Drawings is owner's drawings (D); it decreases owner's equity. 4. Salaries Expense is an expense (E); it decreases owner's equity.

Related exercise material: **BE1-1, BE1-2, BE1-3, BE1-4, BE1-5, E1-5, E1-6, E1-7,** and **DO IT! 1-2**.

✔ The Navigator

USING THE ACCOUNTING EQUATION

STUDY OBJECTIVE 7

Analyze the effects of business transactions on the accounting equation.

Transactions (**business transactions**) are a business's economic events recorded by accountants. Transactions may be external or internal. **External transactions** involve economic events between the company and some outside enterprise. For example, Campus Pizza's purchase of cooking equipment from a supplier, payment of monthly rent to the landlord, and sale of pizzas to customers are external transactions. **Internal transactions** are economic events that occur entirely within one company. The use of cooking and cleaning supplies are internal transactions for Campus Pizza.

Companies carry on many activities that do not represent business transactions. Examples are hiring employees, answering the telephone, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. Illustration 1-7 (page 15) demonstrates the transaction-identification process.

Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding: (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in owner's equity.

Two or more items could be affected. For example, as one asset is increased $10,000, another asset could decrease $6,000 and a liability could increase $4,000. Any change in a liability or ownership claim is subject to similar analysis.

Transaction Analysis

HELPFUL HINT

You will want to study these transactions until you are sure you understand them. They are not difficult, but understanding them is important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential in accounting.

The following examples are business transactions for a computer programming business during its first month of operations.

Transaction (1). Investment By Owner. Ray Neal decides to open a computer programming service which he names Softbyte. On September 1, 2010, he invests $15,000 cash in the business. This transaction results in an equal increase in assets and owner's equity. The asset Cash increases $15,000, as does the owner's equity, identified as R. Neal, Capital. The effect of this transaction on the basic equation is:

	Assets	=	Liabilities	+	Owner's Equity
	Cash	=			R. Neal, Capital
(1)	+$15,000	=			+$15,000

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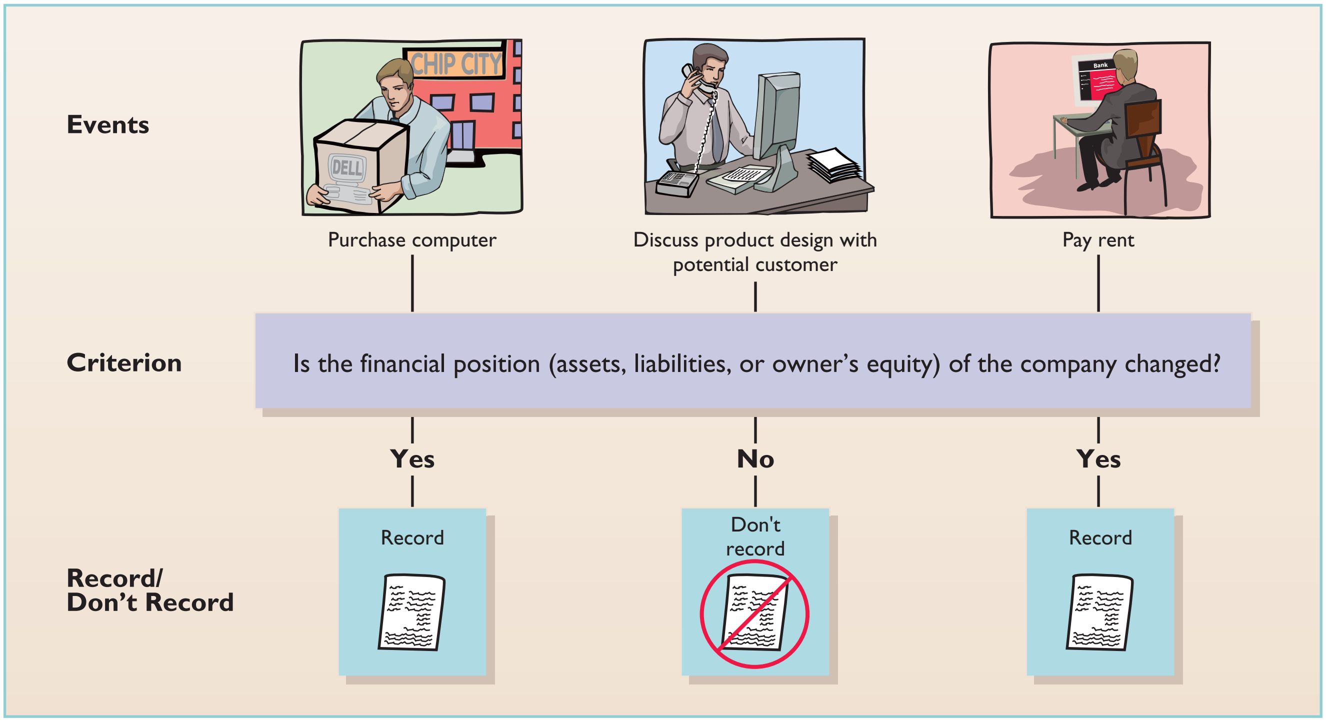

Illustration 1-7
Transaction-identification process

Observe that the equality of the accounting equation has been maintained. Note that the investments by the owner do not represent revenues, and they are excluded in determining net income. Therefore it is necessary to make clear that the increase is an investment (increasing R. Neal, Capital) rather than revenue.

Transaction (2). Purchase of Equipment for Cash. Softbyte purchases computer equipment for $7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes: Cash decreases $7,000, and the asset Equipment increases $7,000. The specific effect of this transaction and the cumulative effect of the first two transactions are:

		Assets			=	Liabilities	+	Owner's Equity
		Cash	+	Equipment	=			R. Neal, Capital
	Old Bal.	$15,000						$15,000
(2)		−7,000		+$7,000				
	New Bal.	$ 8,000	+	$7,000	=			$15,000
		$15,000						

Observe that total assets are still $15,000. Neal's equity also remains at $15,000, the amount of his original investment.

Transaction (3). Purchase of Supplies on Credit. Softbyte purchases for $1,600 from Acme Supply Company computer paper and other supplies expected to last several months. Acme agrees to allow Softbyte to pay this bill in October. This transaction is a purchase on account (a credit purchase). Assets increase because of the expected future benefits of using the paper and supplies, and liabilities increase by

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the amount due Acme Company. The asset Supplies increases $1,600, and the liability Accounts Payable increases by the same amount. The effect on the equation is:

		Assets					=	Liabilities	+	Owner's Equity
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	R. Neal, Capital
	Old Bal.	$8,000				$7,000				$15,000
(3)				+$1,600				+$1,600		
	New Bal.	$8,000	+	$1,600	+	$7,000	=	$1,600	+	$15,000
				$16,600					$16,600	

Total assets are now $16,600. This total is matched by a $1,600 creditor's claim and a $15,000 ownership claim.

Transaction (4). Services Provided for Cash. Softbyte receives $1,200 cash from customers for programming services it has provided. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases owner's equity**. In this transaction, Cash increases $1,200, and revenues (specifically, Service Revenue) increase $1,200. The new balances in the equation are:

		Assets					=	Liabilities	+	Owner's Equity		
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	R. Neal, Capital	+	Revenues
	Old Bal.	$8,000		$1,600		$7,000		$1,600		$15,000		
(4)		+$1,200										+$1,200
	New Bal.	$9,200	+	$1,600	+	$7,000	=	$1,600	+	$15,000	+	$1,200
				$17,800						$17,800		

The two sides of the equation balance at $17,800. Service Revenue is included in determining Softbyte's net income.

Note that we do not have room to give details for each individual revenue and expense account in this illustration. Thus, revenues (and expenses when we get to them) are summarized under one column heading for Revenues and one for Expenses. However, it is important to keep track of the category (account) titles affected (e.g., Service Revenue) as they will be needed when we prepare financial statements later in the chapter.

Transaction (5). Purchase of Advertising on Credit. Softbyte receives a bill for $250 from the *Daily News* for advertising but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in owner's equity. The specific categories involved are Accounts Payable and expenses (specifically, Advertising Expense). The effect on the equation is:

		Assets					=	Liabilities	+	Owner's Equity				
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	R. Neal, Capital	+	Revenues	−	Expenses
	Old Bal.	$9,200		$1,600		$7,000		$1,600		$15,000		$1,200		
(5)								+250						−$250
	New Bal.	$9,200	+	$1,600	+	$7,000	=	$1,850	+	$15,000	+	$1,200	−	$250
				$17,800						$17,800				

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The two sides of the equation still balance at $17,800. Owner's equity decreases when Softbyte incurs the expense. Expenses are not always paid in cash at the time they are incurred. When Softbyte pays at a later date, the liability Accounts Payable will decrease, and the asset Cash will decrease [see Transaction (8)]. The cost of advertising is an expense (rather than an asset) because the company has *used* the benefits. Advertising Expense is included in determining net income.

Transaction (6). Services Provided for Cash and Credit. Softbyte provides $3,500 of programming services for customers. The company receives cash of $1,500 from customers, and it bills the balance of $2,000 on account. This transaction results in an equal increase in assets and owner's equity. Three specific items are affected: Cash increases $1,500; Accounts Receivable increases $2,000; and Service Revenue increases $3,500. The new balances are as follows.

	Assets							=	Liabilities	+	Owner's Equity				
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	R. Neal, Capital	+	Revenues	−	Expenses
Old Bal.	$9,200				$1,600		$7,000		$1,850		$15,000		$1,200		$250
(6)	**+1,500**		**+$2,000**										**+3,500**		
New Bal.	$10,700	+	$2,000	+	$1,600	+	$7,000	=	$1,850	+	$15,000	+	$4,700	−	$250
	$21,300								$21,300						

Softbyte earns revenues when it provides the service, and therefore it recognizes $3,500 in revenue. In exchange for this service, it received $1,500 in Cash and Accounts Receivable of $2,000. This Accounts Receivable represents customers' promise to pay $2,000 to Softbyte in the future. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

Transaction (7). Payment of Expenses. Softbyte pays the following Expenses in cash for September: store rent $600, salaries of employees $900, and utilities $200. These payments result in an equal decrease in assets and expenses. Cash decreases $1,700, and the specific expense categories (Rent Expense, Salaries Expense, and Utility Expense) decrease owner's equity by the same amount. The effect of these payments on the equation is:

	Assets							=	Liabilities	+	Owner's Equity				
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	R. Neal, Capital	+	Revenues	−	Expenses
Old Bal.	$10,700		$2,000		$1,600		$7,000		$1,850		$15,000		$4,700		$ 250
(7)	**−1,700**														**−600**
															−900
															−200
New Bal.	$9,000	+	$2,000	+	$1,600	+	$7,000	=	$1,850	+	$15,000	+	$4,700	−	$1,950
	$19,600								$19,600						

The two sides of the equation now balance at $19,600. Three lines in the analysis indicate the different types of expenses that have been incurred.

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Transaction (8). Payment of Accounts Payable. Softbyte pays its $250 *Daily News* bill in cash. The company previously [in Transaction (5)] recorded the bill as an increase in Accounts Payable and a decrease in owner's equity. This payment "on account" decreases the asset Cash by $250 and also decreases the liability Accounts Payable by $250. The effect of this transaction on the equation is:

	Assets							= Liabilities	+	Owner's Equity				
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	= Accounts Payable	+	R. Neal, Capital	+	Revenues	−	Expenses
Old Bal.	$9,000		$2,000		$1,600		$7,000	$1,850		$15,000		$4,700		$1,950
(8)	−250							−250						
New Bal.	$8,750	+	$2,000	+	$1,600	+	$7,000	= $1,600	+	$15,000	+	$4,700	−	$1,950
	$19,350							$19,350						

Observe that the payment of a liability related to an expense that has previously been recorded does not affect owner's equity. The company recorded this expense in Transaction (5) and should not record it again.

Transaction (9). Receipt of Cash on Account. Softbyte receives $600 in cash from customers who had been billed for services [in Transaction (6)]. This does not change total assets, but it changes the composition of those assets. Cash increases $600 and Accounts Receivable decreases $600. The new balances are:

	Assets							= Liabilities	+	Owner's Equity				
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	= Accounts Payable	+	R. Neal, Capital	+	Revenues	−	Expenses
Old Bal.	$8,750		$2,000		$1,600		$7,000	$1,600		$15,000		$4,700		$1,950
(9)	+600		−600											
New Bal.	$9,350	+	$1,400	+	$1,600	+	$7,000	= $1,600	+	$15,000	+	$4,700	−	$1,950
	$19,350							$19,350						

Note that the collection of an account receivable for services previously billed and recorded does not affect owner's equity. Softbyte already recorded this revenue in Transaction (6) and should not record it again.

Transaction (10). Withdrawal of Cash by Owner. Ray Neal withdraws $1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity. Both Cash and R. Neal, Capital decrease $1,300, as shown below.

	Assets							= Liabilities	+	Owner's Equity						
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	= Accounts Payable	+	R. Neal, Capital	−	R. Neal, Drawings	+	Revenues	−	Expenses
Old Bal.	$9,350		$1,400		$1,600		$7,000	$1,600		$15,000				$4,700		$1,950
(10)	−1,300											−$1,300				
New Bal.	$8,050	+	$1,400	+	$1,600	+	$7,000	= $1,600	+	$15,000	−	$1,300	+	$4,700	−	$1,950
	$18,050							$18,050								

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Observe that the effect of a cash withdrawal by the owner is the opposite of the effect of an investment by the owner. **Owner's drawings are not expenses.** Expenses are incurred for the purpose of earning revenue. Drawings do not generate revenue. They are a **disinvestment**. Like owner's investment, the company excludes owner's drawings in determining net income.

Summary of Transactions

Illustration 1-8 summarizes the September transactions of Softbyte to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction.

	Assets							= Liabilities	+	Owner's Equity						
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	= Accounts Payable	+	R. Neal, Capital	−	R. Neal, Drawings	+	Revenues	−	Expenses
(1)	+$15,000									+$15,000						
(2)	−7,000						+$7,000									
(3)					+$1,600			+$1,600								
(4)	+1,200													+$1,200		
(5)								+250								−$250
(6)	+1,500		+$2,000											+3,500		
(7)	−600															−600
	−900															−900
	−200															−200
(8)	−250							−250								
(9)	+600		−600													
(10)	−1,300											−$1,300				
	$8,050	+	$1,400	+	$1,600	+	$7,000	= $1,600	+	$15,000	−	$1,300	+	$4,700	−	$1,950
	$18,050							$18,050								

Illustration 1-8
Tabular summary of Softbyte transactions

Illustration 1-8 demonstrates some significant facts:

1. Each transaction is analyzed in terms of its effect on:
   (a) the three components of the basic accounting equation.
   (b) specific items within each component.
2. The two sides of the equation must always be equal.

There! You made it through your first transaction analysis. If you feel a bit shaky on any of the transactions, it might be a good idea at this point to get up, take a short break, and come back again for a 10- to 15-minute review of the transactions, to make sure you understand them before you go on to the next section.

DO IT!

TABULAR ANALYSIS

Transactions made by Virmari & Co., a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1-8.

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action plan

✔ Analyze the effects of each transaction on the accounting equation.

✔ Use appropriate category names (not descriptions).

✔ Keep the accounting equation in balance.

1. The owner invested $25,000 cash in the business.
2. The company purchased $7,000 of office equipment on credit.
3. The company received $8,000 cash in exchange for services performed.
4. The company paid $850 for this month's rent.
5. The owner withdrew $1,000 cash for personal use.

Solution

	Assets			=	Liabilities	+	Owner's Equity						
	Cash	+	Office Equipment	=	Accounts Payable	+	A.Virmari, Capital	−	A.Virmari, Drawings	+	Revenues	−	Expenses
1.	+$25,000						+$25,000						
2.			+$7,000		+$7,000								
3.	+8,000										+$8,000		
4.	−850												−$850
5.	−1,000								−$1,000				
	$31,150	+	$7,000	=	$7,000	+	$25,000	−	$1,000	+	$8,000	−	$850
	$38,150				$38,150								

Related exercise material: **BE1-6, BE1-7, BE1-8, BE1-9, E1-6, E1-7, E1-8, E1-10, E1-11,** and **DO IT! 1-3.**

✔ The Navigator

FINANCIAL STATEMENTS

STUDY OBJECTIVE 8

Understand the four financial statements and how they are prepared.

Companies prepare four financial statements from the summarized accounting data:

1. An **income statement** presents the revenues and expenses and resulting net income or net loss for a specific period of time.
2. An **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.
3. A **balance sheet** reports the assets, liabilities, and owner's equity at a specific date.
4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

HELPFUL HINT

The income statement, owner's equity statement, and statement of cash flows are all for a *period* of time, whereas the balance sheet is for a *point* in time.

These statements provide relevant financial data for internal and external users.

Illustration 1-9 (page 21) shows the financial statements of Softbyte. Note that the statements are interrelated:

1. Net income of $2,750 on the **income statement** is added to the beginning balance of owner's capital in the **owner's equity statement**.
2. Owner's capital of $16,450 at the end of the reporting period shown in the **owner's equity statement** is reported on the **balance sheet**.
3. Cash of $8,050 on the **balance sheet** is reported on the **statement of cash flows**.

Also, explanatory notes and supporting schedules are an integral part of every set of financial statements. We illustrate these notes and schedules in later chapters of this textbook.

Be sure to carefully examine the format and content of each statement in Illustration 1-9. We describe the essential features of each in the following sections.

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Illustration 1-9
Financial statements and their interrelationships

SOFTBYTE
Income Statement
For the Month Ended September 30, 2010

Revenues		
Service revenue		$ 4,700
Expenses		
Salaries expense	$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		$ 2,750

SOFTBYTE
Owner's Equity Statement
For the Month Ended September 30, 2010

R. Neal, Capital September 1		$ –0–
Add: Investments	$15,000	
Net income	2,750	17,750
		17,750
Less: Drawings		1,300
R. Neal, Capital, September 30		$16,450

SOFTBYTE
Balance Sheet
September 30, 2010

Assets

Cash	$ 8,050
Accounts receivable	1,400
Supplies	1,600
Equipment	7,000
Total assets	$18,050

Liabilities and Owner's Equity

Liabilities	
Accounts payable	$ 1,600
Owner's equity	
R. Neal, Capital	16,450
Total liabilities and owner's equity	$18,050

SOFTBYTE
Statement of Cash Flows
For the Month Ended September 30, 2010

Cash flows from operating activities		
Cash receipts from revenues		$ 3,300
Cash payments for expenses		(1,950)
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Investments by owner	$15,000	
Drawings by owner	(1,300)	13,700
Net increase in cash		8,050
Cash at the beginning of the period		0
Cash at the end of the period		$ 8,050

1

2

3

HELPFUL HINT

The heading of each statement identifies the company, the type of statement, and the specific date or time period covered by the statement.

HELPFUL HINT

Note that final sums are double-underlined.

HELPFUL HINT

1. Net income is computed first and is needed to determine the ending balance in owner's equity.
2. The ending balance in owner's equity is needed in preparing the balance sheet.
3. The cash shown on the balance sheet is needed in preparing the statement of cash flows.

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Income Statement

Alternative Terminology notes introduce other terms you might hear or read.

ALTERNATIVE TERMINOLOGY

The income statement is sometimes referred to as the *statement of operations, earnings statement,* or *profit and loss statement.*

The income statement reports the revenues and expenses for a specific period of time. (In Softbyte's case, this is "For the Month Ended September 30, 2010.") Softbyte's income statement is prepared from the data appearing in the owner's equity columns of Illustration 1-8.

The income statement lists revenues first, followed by expenses. Finally the statement shows net income (or net loss). **Net income** results when revenues exceed expenses. A **net loss** occurs when expenses exceed revenues.

Although practice varies, we have chosen in our illustrations and homework solutions to list expenses in order of magnitude. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does **not** include investment and withdrawal transactions between the owner and the business in measuring net income. For example, as explained earlier, Ray Neal's withdrawal of cash from Softbyte was not regarded as a business expense.

Owner's Equity Statement

The owner's equity statement reports the changes in owner's equity for a specific period of time. The time period is the same as that covered by the income statement. Data for the preparation of the owner's equity statement come from the owner's equity columns of the tabular summary (Illustration 1-8) and from the income statement. The first line of the statement shows the beginning owner's equity amount (which was zero at the start of the business). Then come the owner's investments, net income (or loss), and the owner's drawings. This statement indicates *why* owner's equity has increased or decreased during the period.

What if Softbyte had reported a net loss in its first month? Let's assume that during the month of September 2010, Softbyte lost $10,000. Illustration 1-10 shows the presentation of a net loss in the owner's equity statement.

Illustration 1-10
Presentation of net loss

SOFTBYTE
Owner's Equity Statement
For the Month Ended September 30, 2010

R. Neal, Capital, September 1		$ –0–
Add: Investments		15,000
		15,000
Less: Drawings	$ 1,300	
Net loss	**10,000**	11,300
R. Neal, Capital, September 30		$ 3,700

If the owner makes any additional investments, the company reports them in the owner's equity statement as investments.

Balance Sheet

Softbyte's balance sheet reports the assets, liabilities, and owner's equity at a specific date (in Softbyte's case, September 30, 2010). The company prepares the

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balance sheet from the column headings of the tabular summary (Illustration 1-8) and the month-end data shown in its last line.

Observe that the balance sheet lists assets at the top, followed by liabilities and owner's equity. Total assets must equal total liabilities and owner's equity. Softbyte reports only one liability—accounts payable—in its balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as follows.

Illustration 1-11
Presentation of liabilities

Liabilities	
Notes payable	$10,000
Accounts payable	63,000
Salaries payable	18,000
Total liabilities	$91,000

The balance sheet is a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

ACCOUNTING ACROSS THE ORGANIZATION

What Do General Mills, Walt Disney, and Dunkin' Donuts Have in Common?

Not every company uses December 31 as the accounting year-end. Some companies whose year-ends differ from December 31 are General Mills, May 27; Walt Disney Productions, September 30; and Dunkin' Donuts Inc., October 31. Why do companies choose the particular year-ends that they do? Many choose to end the accounting year when inventory or operations are at a low. Compiling accounting information requires much time and effort by managers, so companies would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low.

? What year-end would you likely use if you owned a ski resort and ski rental business? What if you owned a college bookstore? Why choose those year-ends?

Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing transactions, (3) its financing transactions, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period.

HELPFUL HINT
Investing activities pertain to investments made by the company, not investments made by the owner.

Reporting the sources, uses, and change in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. The statement of cash flows provides answers to the following simple but important questions.

1. Where did cash come from during the period?
2. What was cash used for during the period?
3. What was the change in the cash balance during the period?

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As shown in Softbyte's statement of cash flows, cash increased $8,050 during the period. Net cash flow provided from operating activities increased cash $1,350. Cash flow from investing transactions decreased cash $7,000. And cash flow from financing transactions increased cash $13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 17 will examine the statement of cash flows in detail.

DO IT!

FINANCIAL STATEMENT ITEMS

Presented below is selected information related to Flanagan Company at December 31, 2010. Flanagan reports financial information monthly.

Office Equipment	$10,000	Utilities Expense	$ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Drawings	5,000

(a) Determine the total assets of Flanagan Company at December 31, 2010.
(b) Determine the net income that Flanagan Company reported for December 2010.
(c) Determine the owner's equity of Flanagan Company at December 31, 2010.

action plan

✔ Remember the basic accounting equation: assets must equal liabilities plus owner's equity.

✔ Review previous financial statements to determine how total assets, net income, and owner's equity are computed.

Solution

(a) The total assets are $27,000, comprised of Cash $8,000, Accounts Receivable $9,000, and Office Equipment $10,000.

(b) Net income is $14,000, computed as follows:

Revenues		
Service revenue		$36,000
Expenses		
Rent expense	$11,000	
Wages expense	7,000	
Utilities expense	4,000	
Total expenses		22,000
Net income		$14,000

(c) The ending owner's equity of Flanagan Company is $8,500. By rewriting the accounting equation, we can compute owner's equity as assets minus liabilities, as follows:

Total assets [as computed in (a)]		$27,000
Less: Liabilities		
Notes payable	$16,500	
Accounts payable	2,000	18,500
Owner's equity		$ 8,500

Note that it is not possible to determine the company's owner's equity in any other way, because the beginning total for owner's equity is not provided.

✔ The Navigator

Be sure to read **ALL ABOUT YOU: *Ethics: Managing Personal Financial Reporting*** on page 25 for information on how topics in this chapter apply to your personal life.

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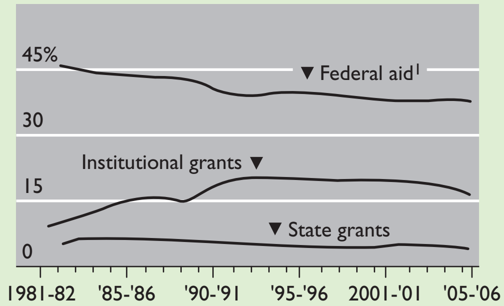
Ethics: Managing Personal Financial Reporting

When companies need money, they go to investors or creditors. Before investors or creditors will give a company cash, they want to know the company's financial position and performance. They want to see the company's financial statements—the balance sheet and the income statement. When students need money for school, they often apply for financial aid. When you apply for financial aid, you must submit your own version of a financial statement—the Free Application for Federal Student Aid (FAFSA) form.

The FAFSA form asks how much you make (based on your federal income tax return) and how much your parents make. The purpose is to find out how much you own and how much you owe. Why do the Department of Education and your school want this information? Simple: They want to know whether you really need the money. Schools and government-loan funds have limited resources, and they want to make sure that the money goes to those who need it the most. The bottom line is: The worse off you look financially, the more likely you are to get money.

The question is: Should you intentionally make yourself look worse off than you are?

The federal share of assistance is declining
Sources of financial aid as a percentage of total aid used to finance postsecondary expenses



Source for graph: College Board, *Princeton Review*, as reported in "College Admissions: Is Gate Open or Closed?," *Wall Street Journal*, March 25, 2006, p. A7.

Some Facts

- After adjusting for inflation, private-college tuition and fees have increased 37% over the past decade; public-college tuition has risen 54%.
- Two-thirds (65.6%) of undergraduate students graduate with some debt.
- Among graduating seniors, the average debt load is $19,202, according to an analysis of data from the Department of Education's National Postsecondary Student Aid Study. That does not include any debt that their parents might incur.
- Colleges are required to audit the FAFSA forms of at least one-third of their students; some audit 100%. (Compare that to the IRS, which audits a very small percentage of tax returns.) Thus, if you lie on your financial aid forms, there's a very good chance you'll get caught.

Additional information regarding scholarships and loans is available at ***www.finaid.org/.*** You might find especially interesting the section that discusses how to maximize your chances of obtaining financial aid at ***www.finaid.org/fafsa/maximize.phtml.***

What Do You Think?

Consider the following and decide what action you would take:

Suppose you have $4,000 in cash and $4,000 in credit card bills. The more cash and other assets that you have, the less likely you are to get financial aid. Also, if you have a lot of consumer debt (credit card bills), schools are not more likely to loan you money. To increase your chances of receiving aid, should you use the cash to pay off your credit card bills, and therefore make yourself look "worse off" to the financial aid decision makers?

YES: You are playing within the rules. You are not hiding assets. You are simply restructuring your assets and liabilities to best conform with the preferences that are built into the federal aid formulas.

NO: You are engaging in a transaction solely to take advantage of a loophole in the federal aid rules. In doing so, you are potentially depriving someone who is actually worse off than you from receiving aid.

Sources: "College Admissions: Is Gate Open or Closed?," *Wall Street Journal,* March 25, 2006, P. A7; *www.finaid.org.*

The authors' comments on this situation appear on page 46.

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Comprehensive DO IT!

*The **Comprehensive Do It!** is a final review of the chapter. The **Action Plan** gives tips about how to approach the problem, and the **Solution** demonstrates both the form and content of complete answers.*

Joan Robinson opens her own law office on July 1, 2010. During the first month of operations, the following transactions occurred.

1. Joan invested $11,000 in cash in the law practice.
2. Paid $800 for July rent on office space.
3. Purchased office equipment on account $3,000.
4. Provided legal services to clients for cash $1,500.
5. Borrowed $700 cash from a bank on a note payable.
6. Performed legal services for client on account $2,000.
7. Paid monthly expenses: salaries $500, utilities $300, and telephone $100.
8. Joan withdraws $1,000 cash for personal use.

Instructions

(a) Prepare a tabular summary of the transactions.

(b) Prepare the income statement, owner's equity statement, and balance sheet at July 31 for Joan Robinson, Attorney.

Solution to Comprehensive DO IT!

(a)

	Assets					=	Liabilities			+	Owner's Equity						
Trans-action	Cash	+	Accounts Receivable	+	Equipment	=	Note Payable	+	Accounts Payable	+	J. Robinson, Capital	−	J. Robinson, Drawings	+	Revenues	−	Expenses
(1)	+$11,000					=					+$11,000						
(2)	−800																−$800
(3)					+$3,000	=			+$3,000								
(4)	+1,500														+$1,500		
(5)	+700						+$700										
(6)			+$2,000												+2,000		
(7)	−500																−500
	−300																−300
	−100																−100
(8)	−1,000												−$1,000				
	$10,500	+	$2,000	+	$3,000	=	$700	+	$3,000	+	$11,000	−	$1,000	+	$3,500	−	$1,700
			$15,500								$15,500						

action plan

- ✔ Make sure that assets equal liabilities plus owner's equity after each transaction.
- ✔ Investments and revenues increase owner's equity. Withdrawals and expenses decrease owner's equity.
- ✔ Prepare the financial statements in the order listed.
- ✔ The income statement shows revenues and expenses for a period of time.
- ✔ The statement of owner's equity shows the changes in owner's equity for the same period of time as the income statement.
- ✔ The balance sheet reports assets, liabilities, and owner's equity at a specific date.

(b)

JOAN ROBINSON, ATTORNEY
INCOME STATEMENT
Month Ended July 31, 2010

Revenues		
Service revenue		$3,500
Expenses		
Rent expense	$800	
Salaries expense	500	
Utilities expense	300	
Telephone expense	100	
Total expenses		1,700
Net income		$1,800

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JOAN ROBINSON, ATTORNEY
STATEMENT OF OWNER'S EQUITY
Month Ended July 31, 2010

J. Robinson, Capital, July 1		$ 0
Add: Investments	$11,000	
Net income	1,800	12,800
		12,800
Less: Drawings		1,000
J. Robinson, Capital, July 31		$11,800

JOAN ROBINSON, ATTORNEY
BALANCE SHEET
July 31, 2010

Assets	
Cash	$10,500
Accounts receivable	2,000
Equipment	3,000
Total assets	$15,500
Liabilities and Owner's Equity	
Liabilities	
Notes payable	$ 700
Accounts payable	3,000
Total liabilities	3,700
Owner's equity	
J. Robinson, Capital	11,800
Total liabilities and owner's equity	$15,500

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This would be a good time to return to the ***Student Owner's Manual*** *at the beginning of the book (or look at it for the first time if you skipped it before) to read about the various types of assignment materials that appear at the end of each chapter. Knowing the purpose of the different assignments will help you appreciate what each contributes to your accounting skills and competencies.*

SUMMARY OF STUDY OBJECTIVES

1 **Explain what accounting is.** Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users.

2 **Identify the users and uses of accounting.** The major users and uses of accounting are as follows: (a) Management uses accounting information in planning, controlling, and evaluating business operations. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, labor unions, and economic planners.

3 **Understand why ethics is a fundamental business concept.** Ethics are the standards of conduct by which actions are judged as right or wrong. If you cannot depend on the honesty of the individuals you deal with, effective communication and economic activity would be impossible, and information would have no credibility.

4 **Explain generally accepted accounting principles and the cost principle.** Generally accepted accounting principles are a common set of standards used by accountants. The cost principle states that companies should record assets at their cost.

5 **Explain the monetary unit assumption and the economic entity assumption.** The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept

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separate from the activities of its owner and other economic entities.

6 **State the accounting equation, and define its components.** The basic accounting equation is:

Assets = Liabilities + Owner's Equity

Assets are resources owned by a business. Liabilities are creditorship claims on total assets. Owner's equity is the ownership claim on total assets.

The expanded accounting equation is:

Assets = Liabilities + Owner's Capital − Owner's Drawings + Revenues − Expenses

Owner's capital is assets the owner puts into the business. Owner's drawings are the assets the owner withdraws for personal use. Revenues are increases in assets resulting from income-earning activities. Expenses are the costs of assets consumed in the process of earning revenue.

7 **Analyze the effects of business transactions on the accounting equation.** Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be a corresponding (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in owner's equity.

8 **Understand the four financial statements and how they are prepared.** An income statement presents the revenues and expenses of a company for a specified period of time. An owner's equity statement summarizes the changes in owner's equity that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and owner's equity of a business at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

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GLOSSARY

Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 4).

Assets Resources a business owns. (p. 12).

Balance sheet A financial statement that reports the assets, liabilities, and owner's equity at a specific date. (p. 20).

Basic accounting equation Assets = Liabilities + Owner's Equity. (p. 12).

Bookkeeping A part of accounting that involves only the recording of economic events. (p. 5).

Corporation A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock. (p. 10).

Cost principle An accounting principle that states that companies should record assets at their cost. (p. 9).

Drawings Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s). (p. 13).

Economic entity assumption An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. (p. 9).

Ethics The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 8).

Expanded accounting equation Assets = Liabilities + Owner's Capital − Owner's Drawings + Revenues − Expenses. (p. 13).

Expenses The cost of assets consumed or services used in the process of earning revenue. (p. 13).

Financial accounting The field of accounting that provides economic and financial information for investors, creditors, and other external users. (p. 7).

Financial Accounting Standards Board (FASB) A private organization that establishes generally accepted accounting principles (GAAP). (p. 8).

Generally accepted accounting principles (GAAP) Common standards that indicate how to report economic events. (p. 8).

Income statement A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. (p. 20).

International Accounting Standards Board (IASB) An accounting standard-setting body that issues standards adopted by many countries outside of the United States. (p. 9).

Investments by owner The assets an owner puts into the business. (p. 13).

Liabilities Creditor claims on total assets. (p. 12).

Managerial accounting The field of accounting that provides internal reports to help users make decisions about their companies. (p. 6).

Monetary unit assumption An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money. (p. 9).

Net income The amount by which revenues exceed expenses. (p. 22).

Net loss The amount by which expenses exceed revenues. (p. 22).

Owner's equity The ownership claim on total assets. (p. 12).

Owner's equity statement A financial statement that summarizes the changes in owner's equity for a specific period of time. (p. 20).

Partnership A business owned by two or more persons associated as partners. (p. 10).

Proprietorship A business owned by one person. (p. 10).

Revenues The gross increase in owner's equity resulting from business activities entered into for the purpose of earning income. (p. 13).

Sarbanes-Oxley Act of 2002 (SOX) Law passed by Congress in 2002 intended to reduce unethical corporate behavior. (p. 8).

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Securities and Exchange Commission (SEC) A governmental agency that requires companies to file financial reports in accordance with generally accepted accounting principles. (p. 8).

Statement of cash flows A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time. (p. 20).

Transactions The economic events of a business that are recorded by accountants. (p. 14).

APPENDIX Accounting Career Opportunities

STUDY OBJECTIVE 9
Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice? First, there are a lot of jobs. In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, "accounting is one degree with 360 degrees of opportunity."

Accounting is also hot because it is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the accounting failures of companies such as Enron and WorldCom. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society. Finally, the Sarbanes-Oxley Act of 2002 (SOX) (see page 8) significantly increased the accounting and internal control requirements for corporations. This dramatically increased demand for professionals with accounting training.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients. A major portion of public accounting involves **auditing**. In auditing, a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position. Analysts, investors, and creditors rely heavily on these "audit opinions," which CPAs have the exclusive authority to issue.

Taxation is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies such as the Internal Revenue Service.

A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to providing support services for major marketing projects or merger and acquisition activities.

Many CPAs are entrepreneurs. They form small- or medium-sized practices that frequently specialize in tax or consulting services.

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as Starbucks, Google, or PepsiCo. In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, or tax planning and preparation. You

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might also be a member of your company's internal audit team. In response to SOX, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

Alternatively, many accountants work for not-for-profit organizations such as the Red Cross or the Bill and Melinda Gates Foundation, or for museums, libraries, or performing arts organizations.

Opportunities in Government

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, the Internal Revenue Service (IRS), Federal Bureau of Investigation (FBI), and the Securities and Exchange Commission (SEC) all employ accountants. The FBI has a stated goal that at least 15 percent of its new agents should be CPAs. There is also a very high demand for accounting educators at public colleges and universities and in state and local governments.

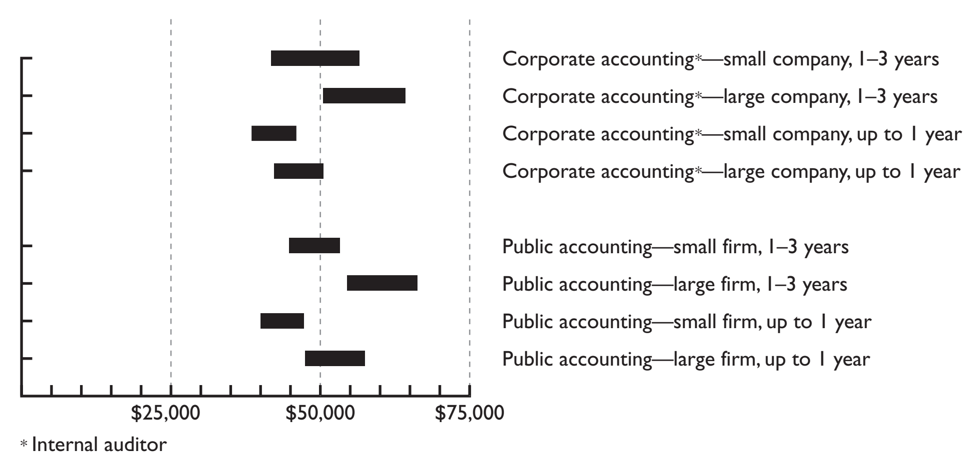
Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future. The job of forensic accountants is to catch the perpetrators of the estimated $600 billion per year of theft and fraud occurring at U.S. companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces. Forensic accountants often have FBI, IRS, or similar government experience.

"Show Me the Money"

How much can a new accountant make? Salary estimates are constantly changing, and salaries vary considerably across the country. At the time this text was written, the following general information was available from Robert Half International.

Illustration 1A-1
Salary estimates for jobs in public and corporate accounting



The average salary for a first-year partner in a CPA firm is close to $130,000, with experienced partners often making substantially more. On the corporate side, controllers (the head accountant) can earn $150,000, while chief financial officers can earn as much as $350,000.

For up-to-date salary estimates, as well as a wealth of additional information regarding accounting as a career, check out *www.startheregoplaces.com*.

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SUMMARY OF STUDY OBJECTIVE FOR APPENDIX

9 **Explain the career opportunities in accounting.** Accounting offers many different jobs in fields such as public and private accounting, government, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

GLOSSARY FOR APPENDIX

Auditing The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 29).

Forensic accounting An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 30).

Management consulting An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 29).

Private (or managerial) accounting An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation. (p. 29).

Public accounting An area of accounting in which the accountant offers expert service to the general public. (p. 29).

Taxation An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 29).

SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

(SO 1) **1.** Which of the following is *not* a step in the accounting process?
- **a.** identification.
- **b.** verification.
- **c.** recording.
- **d.** communication.

(SO 2) **2.** Which of the following statements about users of accounting information is *incorrect*?
- **a.** Management is an internal user.
- **b.** Taxing authorities are external users.
- **c.** Present creditors are external users.
- **d.** Regulatory authorities are internal users.

(SO 4) **3.** The cost principle states that:
- **a.** assets should be initially recorded at cost and adjusted when the market value changes.
- **b.** activities of an entity are to be kept separate and distinct from its owner.
- **c.** assets should be recorded at their cost.
- **d.** only transaction data capable of being expressed in terms of money be included in the accounting records.

(SO 5) **4.** Which of the following statements about basic assumptions is *correct*?
- **a.** Basic assumptions are the same as accounting principles.
- **b.** The economic entity assumption states that there should be a particular unit of accountability.
- **c.** The monetary unit assumption enables accounting to measure employee morale.
- **d.** Partnerships are not economic entities.

(SO 5) **5.** The three types of business entities are:
- **a.** proprietorships, small businesses, and partnerships.
- **b.** proprietorships, partnerships, and corporations.
- **c.** proprietorships, partnerships, and large businesses.
- **d.** financial, manufacturing, and service companies.

6. Net income will result during a time period when: (SO 6)
- **a.** assets exceed liabilities.
- **b.** assets exceed revenues.
- **c.** expenses exceed revenues.
- **d.** revenues exceed expenses.

7. Performing services on account will have the following effects on the components of the basic accounting equation: (SO 7)
- **a.** increase assets and decrease owner's equity.
- **b.** increase assets and increase owner's equity.
- **c.** increase assets and increase liabilities.
- **d.** increase liabilities and increase owner's equity.

8. As of December 31, 2010, Stoneland Company has assets of $3,500 and owner's equity of $2,000. What are the liabilities for Stoneland Company as of December 31, 2010? (SO 7)
- **a.** $1,500.
- **b.** $1,000.
- **c.** $2,500.
- **d.** $2,000.

9. Which of the following events is *not* recorded in the accounting records? (SO 7)
- **a.** Equipment is purchased on account.
- **b.** An employee is terminated.
- **c.** A cash investment is made into the business.
- **d.** The owner withdraws cash for personal use.

10. During 2010, Gibson Company's assets decreased $50,000 and its liabilities decreased $90,000. Its owner's equity therefore: (SO 7)
- **a.** increased $40,000.
- **b.** decreased $140,000.
- **c.** decreased $40,000.
- **d.** increased $140,000.

11. Payment of an account payable affects the components of the accounting equation in the following way. (SO 7)
- **a.** Decreases owner's equity and decreases liabilities.
- **b.** Increases assets and decreases liabilities.

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c. Decreases assets and increases owner's equity.
d. Decreases assets and decreases liabilities.

(SO 8) **12.** Which of the following statements is *false*?
a. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
b. A balance sheet reports the assets, liabilities, and owner's equity at a specific date.
c. An income statement presents the revenues, expenses, changes in owner's equity, and resulting net income or net loss for a specific period of time.
d. An owner's equity statement summarizes the changes in owner's equity for a specific period of time.

(SO 8) **13.** On the last day of the period, Jim Otto Company buys a $900 machine on credit. This transaction will affect the:
a. income statement only.
b. balance sheet only.
c. income statement and owner's equity statement only.
d. income statement, owner's equity statement, and balance sheet.

14. The financial statement that reports assets, liabilities, and owner's equity is the: (SO 8)
a. income statement.
b. owner's equity statement.
c. balance sheet.
d. statement of cash flow.

***15.** Services provided by a public accountant include: (SO 9)
a. auditing, taxation, and management consulting.
b. auditing, budgeting, and management consulting.
c. auditing, budgeting, and cost accounting.
d. internal auditing, budgeting, and management consulting.

Go to the book's companion website, **www.wiley.com/college/weygandt**, for Additional Self-Study questions.

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QUESTIONS

1. "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.

2. Identify and describe the steps in the accounting process.

3. (a) Who are internal users of accounting data? (b) How does accounting provide relevant data to these users?

4. What uses of financial accounting information are made by (a) investors and (b) creditors?

5. "Bookkeeping and accounting are the same." Do you agree? Explain.

6. Karen Sommers Travel Agency purchased land for $90,000 cash on December 10, 2010. At December 31, 2010, the land's value has increased to $93,000. What amount should be reported for land on Karen Sommers's balance sheet at December 31, 2010? Explain.

7. What is the monetary unit assumption?

8. What is the economic entity assumption?

9. What are the three basic forms of business organizations for profit-oriented enterprises?

10. Maria Gonzalez is the owner of a successful printing shop. Recently her business has been increasing, and Maria has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Maria would enjoy if she were to incorporate her business.

11. What is the basic accounting equation?

12. **(a)** Define the terms assets, liabilities, and owner's equity.
(b) What items affect owner's equity?

13. Which of the following items are liabilities of Stanley Jewelry Stores?
(a) Cash. **(d)** Accounts receivable.
(b) Accounts payable. **(e)** Supplies.
(c) Drawings. **(f)** Equipment.
(g) Salaries payable. **(i)** Rent expense.
(h) Service revenue.

14. Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.

15. Are the following events recorded in the accounting records? Explain your answer in each case.
(a) The owner of the company dies.
(b) Supplies are purchased on account.
(c) An employee is fired.
(d) The owner of the business withdraws cash from the business for personal use.

16. Indicate how the following business transactions affect the basic accounting equation.
(a) Paid cash for janitorial services.
(b) Purchased equipment for cash.
(c) Invested cash in the business.
(d) Paid accounts payable in full.

17. Listed below are some items found in the financial statements of Alex Greenspan Co. Indicate in which financial statement(s) the following items would appear.
(a) Service revenue. **(d)** Accounts receivable.
(b) Equipment. **(e)** Alex Greenspan, Capital.
(c) Advertising expense. **(f)** Wages payable.

18. In February 2010, Paula King invested an additional $10,000 in her business, King's Pharmacy, which is organized as a proprietorship. King's accountant, Lance Jones, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?

19. "A company's net income appears directly on the income statement and the owner's equity statement, and it is included indirectly in the company's balance sheet." Do you agree? Explain.

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20. Garcia Enterprises had a capital balance of $168,000 at the beginning of the period. At the end of the accounting period, the capital balance was $198,000.

(a) Assuming no additional investment or withdrawals during the period, what is the net income for the period?

(b) Assuming an additional investment of $13,000 but no withdrawals during the period, what is the net income for the period?

21. Summarized operations for J. R. Ross Co. for the month of July are as follows.

Revenues earned: for cash $20,000; on account $70,000.

Expenses incurred: for cash $26,000; on account $40,000.

Indicate for J. R. Ross Co. (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.

22. The basic accounting equation is: Assets = Liabilities + Owner's Equity. Replacing the words in that equation with dollar amounts, what is Coca-Cola's accounting equation at December 31, 2007? (*Hint*: Owner's equity is equivalent to shareowners' equity.)

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BRIEF EXERCISES

BE1-1 Presented below is the basic accounting equation. Determine the missing amounts.

Use basic accounting equation. (SO 6)

	Assets	=	Liabilities	+	Owner's Equity
(a)	$90,000		$50,000		?
(b)	?		$40,000		$70,000
(c)	$94,000		?		$60,000

BE1-2 Given the accounting equation, answer each of the following questions.

Use basic accounting equation. (SO 6)

(a) The liabilities of McGlone Company are $120,000 and the owner's equity is $232,000. What is the amount of McGlone Company's total assets?

(b) The total assets of Company are $190,000 and its owner's equity is $80,000. What is the amount of its total liabilities?

(c) The total assets of McGlone Co. are $800,000 and its liabilities are equal to one half of its total assets. What is the amount of McGlone Co.'s owner's equity?

BE1-3 At the beginning of the year, Hernandez Company had total assets of $800,000 and total liabilities of $500,000. Answer the following questions.

Use basic accounting equation. (SO 6)

(a) If total assets increased $150,000 during the year and total liabilities decreased $80,000, what is the amount of owner's equity at the end of the year?

(b) During the year, total liabilities increased $100,000 and owner's equity decreased $70,000. What is the amount of total assets at the end of the year?

(c) If total assets decreased $80,000 and owner's equity increased $120,000 during the year, what is the amount of total liabilities at the end of the year?

BE1-4 Use the expanded accounting equation to answer each of the following questions:

Solve expanded accounting equation. (SO 6)

(a) The liabilities of Cai Company are $90,000. Meiyu Cai's capital account is $150,000; drawings are $40,000; revenues, $450,000; and expenses, $320,000. What is the amount of Cai Company's total assets?

(b) The total assets of Pereira Company are $57,000. Karen Perry's capital account is $25,000; drawings are $7,000; revenues, $50,000; and expenses, $35,000. What is the amount of the company's total liabilities?

(c) The total assets of Yap Co. are $600,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Yap Co.'s owner's equity?

BE1-5 Indicate whether each of the following items is an asset (A), liability (L), or part of owner's equity (OE).

Identify assets, liabilities, and owner's equity. (SO 6)

_______**(a)** Accounts receivable
_______**(b)** Salaries payable
_______**(c)** Equipment
_______**(d)** Office supplies
_______**(e)** Owner's investment
_______**(f)** Notes payable

BE1-6 Presented below are three business transactions. On a sheet of paper, list the letters (a), (b), (c) with columns for assets, liabilities, and owner's equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and owner's equity.

Determine effect of transactions on basic accounting equation. (SO 7)

(a) Purchased supplies on account.
(b) Received cash for providing a service.
(c) Paid expenses in cash.

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Determine effect of transactions on basic accounting equation.
(SO 7)

BE1-7 Follow the same format as BE1-6 on the previous page. Determine the effect on assets, liabilities, and owner's equity of the following three transactions.

(a) Invested cash in the business.
(b) Withdrawal of cash by owner.
(c) Received cash from a customer who had previously been billed for services provided.

Classify items affecting owner's equity.
(SO 7)

BE1-8 Classify each of the following items as owner's drawing (D), revenue (R), or expense (E).

_______**(a)** Advertising expense
_______**(b)** Commission revenue
_______**(c)** Insurance expense
_______**(d)** Salaries expense
_______**(e)** Bergman, Drawing
_______**(f)** Rent revenue
_______**(g)** Utilities expense

Determine effect of transactions on basic owner's equity.
(SO 7)

BE1-9 Presented below are three transactions. Mark each transaction as affecting owner's investment (I), owner's drawings (D), revenue (R), expense (E), or not affecting owner's equity (NOE).

_______**(a)** Received cash for services performed
_______**(b)** Paid cash to purchase equipment
_______**(c)** Paid employee salaries

Prepare a balance sheet.
(SO 8)

BE1-10 In alphabetical order below are balance sheet items for Lopez Company at December 31, 2010. Kim Lopez is the owner of Lopez Company. Prepare a balance sheet, following the format of Illustration 1-9.

Accounts payable	\$90,000
Accounts receivable	\$72,500
Cash	\$49,000
Kim Lopez, Capital	\$31,500

Determine where items appear on financial statements.
(SO 8)

BE1-11 Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or owner's equity statement (OE).

_______**(a)** Notes payable
_______**(b)** Advertising expense
_______**(c)** Trent Buchanan, Capital
_______**(d)** Cash
_______**(e)** Service revenue

DO IT! REVIEW

Review basic concepts.
(SO 1, 2, 4)

DO IT! 1-1 Indicate whether each of the five statements presented below is true or false.

1. The three steps in the accounting process are identification, recording, and examination.
2. The two most common types of external users are investors and creditors.
3. Congress passed the Sarbanes-Oxley Act of 2002 to ensure that investors invest only in companies that will be profitable.
4. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
5. The cost principle dictates that companies record assets at their cost and continue to report them at their cost over the time the asset is held.

Evaluate effects of transactions on owner's equity.
(SO 6)

DO IT! 1-2 Classify the following items as investment by owner (I), owner's drawings (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases owner's equity.

(1) Drawings
(2) Rent Revenue
(3) Advertising Expense
(4) Owner puts personal assets into the business

Prepare tabular analysis.
(SO 7)

DO IT! 1-3 Transactions made by Orlando Carbrera and Co., a law firm, for the month of March are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1-8.

1. The company provided \$20,000 of services for customers, on credit.
2. The company received \$20,000 in cash from customers who had been billed for services [in transaction (1)].
3. The company received a bill for \$2,000 of advertising, but will not pay it until a later date.
4. Orlando Carbrera withdrew \$5,000 cash from the business for personal use.

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DO IT! 1-4 Presented below is selected information related to Broadway Company at December 31, 2010. Broadway reports financial information monthly.

Calculate effects of transactions on financial statement items. (SO 8)

Accounts Payable	$ 3,000	Salaries Expense	$16,500
Cash	7,000	Note Payable	25,000
Advertising Expense	6,000	Rent Expense	10,500
Service Revenue	54,000	Accounts Receivable	13,500
Equipment	29,000	Drawings	7,500

(a) Determine the total assets of Broadway Company at December 31, 2010.
(b) Determine the net income that Broadway Company reported for December 2010.
(c) Determine the owner's equity of Broadway Company at December 31, 2010.

EXERCISES

E1-1 Urlacher Company performs the following accounting tasks during the year.

Classify the three activities of accounting. (SO 1)

______Analyzing and interpreting information.
______Classifying economic events.
______Explaining uses, meaning, and limitations of data.
______Keeping a systematic chronological diary of events.
______Measuring events in dollars and cents.
______Preparing accounting reports.
______Reporting information in a standard format.
______Selecting economic activities relevant to the company.
______Summarizing economic events.

Accounting is "an information system that **identifies**, **records**, and **communicates** the economic events of an organization to interested users."

Instructions
Categorize the accounting tasks performed by Urlacher as relating to either the identification (I), recording (R), or communication (C) aspects of accounting.

E1-2 **(a)** The following are users of financial statements.

Identify users of accounting information. (SO 2)

______Customers	______Securities and Exchange Commission
______Internal Revenue Service	______Store manager
______Labor unions	______Suppliers
______Marketing manager	______Vice-president of finance
______Production supervisor	

Instructions
Identify the users as being either **external users** or **internal users**.

(b) The following questions could be asked by an internal user or an external user.

______Can we afford to give our employees a pay raise?
______Did the company earn a satisfactory income?
______Do we need to borrow in the near future?
______How does the company's profitability compare to other companies?
______What does it cost us to manufacture each unit produced?
______Which product should we emphasize?
______Will the company be able to pay its short-term debts?

Instructions
Identify each of the questions as being more likely asked by an **internal user** or an **external user**.

E1-3 Larry Smith, president of Smith Company, has instructed Ron Rivera, the head of the accounting department for Smith Company, to report the company's land in the company's accounting reports at its market value of $170,000 instead of its cost of $100,000. Smith says, "Showing the land at $170,000 will make our company look like a better investment when we try to attract new investors next month."

Discuss ethics and the cost principle. (SO 3)

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Instructions

Explain the ethical situation involved for Ron Rivera, identifying the stakeholders and the alternatives.

Use accounting concepts.
(SO 4, 5)

E1-4 The following situations involve accounting principles and assumptions.

1. Grossman Company owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Grossman reports the buildings at market value in its accounting reports.
2. Jones Company includes in its accounting records only transaction data that can be expressed in terms of money.
3. Caleb Borke, owner of Caleb's Cantina, records his personal living costs as expenses of the Cantina.

Instructions

For each of the three situations, say if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

Classify accounts as assets, liabilities, and owner's equity.
(SO 6)

E1-5 Meredith Cleaners has the following balance sheet items.

Accounts payable	Accounts receivable
Cash	Notes payable
Cleaning equipment	Salaries payable
Cleaning supplies	Karin Meredith, Capital

Instructions

Classify each item as an asset, liability, or owner's equity.

Analyze the effect of transactions.
(SO 6, 7)

E1-6 Selected transactions for Evergreen Lawn Care Company are listed below.

1. Made cash investment to start business.
2. Paid monthly rent.
3. Purchased equipment on account.
4. Billed customers for services performed.
5. Withdrew cash for owner's personal use.
6. Received cash from customers billed in (4).
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

List the numbers of the above transactions and describe the effect of each transaction on assets, liabilities, and owner's equity. For example, the first answer is: (1) Increase in assets and increase in owner's equity.

Analyze the effect of transactions on assets, liabilities, and owner's equity.
(SO 6, 7)

E1-7 Brandon Computer Timeshare Company entered into the following transactions during May 2010.

1. Purchased computer terminals for $20,000 from Digital Equipment on account.
2. Paid $4,000 cash for May rent on storage space.
3. Received $15,000 cash from customers for contracts billed in April.
4. Provided computer services to Fisher Construction Company for $3,000 cash.
5. Paid Northern States Power Co. $11,000 cash for energy usage in May.
6. Brandon invested an additional $32,000 in the business.
7. Paid Digital Equipment for the terminals purchased in (1) above.
8. Incurred advertising expense for May of $1,200 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

(a) an increase in assets and a decrease in assets.
(b) an increase in assets and an increase in owner's equity.
(c) an increase in assets and an increase in liabilities.
(d) a decrease in assets and a decrease in owner's equity.
(e) a decrease in assets and a decrease in liabilities.
(f) an increase in liabilities and a decrease in owner's equity.
(g) an increase in owner's equity and a decrease in liabilities.

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E1-8 An analysis of the transactions made by S. Moses & Co., a certified public accounting firm, for the month of August is shown below. The expenses were $650 for rent, $4,900 for salaries, and $500 for utilities.

Analyze transactions and compute net income.
(SO 7)

	Cash	+ Accounts Receivable	+ Supplies	+ Office Equipment	= Accounts Payable	+ S. Moses, Capital	− S. Moses, Drawings	+ Revenues	− Expenses
1.	+$15,000					+$15,000			
2.	−2,000			+$5,000	+$3,000				
3.	−750		+$750						
4.	+4,600	+$3,700						+$8,300	
5.	−1,500				−1,500				
6.	−2,000						−$2,000		
7.	−650								–$650
8.	+450	−450							
9.	−4,900								−4,900
10.					+500				–500

Instructions

(a) Describe each transaction that occurred for the month.
(b) Determine how much owner's equity increased for the month.
(c) Compute the amount of net income for the month.

E1-9 An analysis of transactions for S. Moses & Co. was presented in E1–8.

Prepare financial statements.
(SO 8)

Instructions

Prepare an income statement and an owner's equity statement for August and a balance sheet at August 31, 2010.

E1-10 Lily Company had the following assets and liabilities on the dates indicated.

Determine net income (or loss).
(SO 7)

December 31	Total Assets	Total Liabilities
2009	$400,000	$250,000
2010	$460,000	$300,000
2011	$590,000	$400,000

Lily began business on January 1, 2009, with an investment of $100,000.

Instructions

From an analysis of the change in owner's equity during the year, compute the net income (or loss) for:

(a) 2009, assuming Lily's drawings were $15,000 for the year.
(b) 2010, assuming Lily made an additional investment of $50,000 and had no drawings in 2010.
(c) 2011, assuming Lily made an additional investment of $15,000 and had drawings of $30,000 in 2011.

E1-11 Two items are omitted from each of the following summaries of balance sheet and income statement data for two proprietorships for the year 2010, Craig Cantrel and Mills Enterprises.

Analyze financial statements items.
(SO 6, 7)

	Craig Cantrel	Mills Enterprises
Beginning of year:		
Total assets	$ 95,000	$129,000
Total liabilities	85,000	(c)
Total owner's equity	(a)	80,000
End of year:		
Total assets	160,000	180,000
Total liabilities	120,000	50,000
Total owner's equity	40,000	130,000
Changes during year in owner's equity:		
Additional investment	(b)	25,000
Drawings	24,000	(d)
Total revenues	215,000	100,000
Total expenses	175,000	55,000

Instructions

Determine the missing amounts.

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Prepare income statement and owner's equity statement.
(SO 8)

E1-12 The following information relates to Linda Stanley Co. for the year 2010.

Linda Stanley, Capital, January 1, 2010	$ 48,000	Advertising expense	$ 1,800
Linda Stanley, Drawing during 2010	6,000	Rent expense	10,400
Service revenue	62,500	Utilities expense	3,100
Salaries expense	30,000		

Instructions
After analyzing the data, prepare an income statement and an owner's equity statement for the year ending December 31, 2010.

Correct an incorrectly prepared balance sheet.
(SO 8)

E1-13 Mary Close is the bookkeeper for Mendez Company. Mary has been trying to get the balance sheet of Mendez Company to balance. Mendez's balance sheet is shown below.

MENDEZ COMPANY
Balance Sheet
December 31, 2010

Assets		Liabilities	
Cash	$15,000	Accounts payable	$20,000
Supplies	8,000	Accounts receivable	(8,500)
Equipment	46,000	Mendez, Capital	67,500
Mendez, Drawing	10,000	Total liabilities and	
Total assets	$79,000	owner's equity	$79,000

Instructions
Prepare a correct balance sheet.

Compute net income and prepare a balance sheet.
(SO 8)

E1-14 Jan Nab is the sole owner of Deer Park, a public camping ground near the Lake Mead National Recreation Area. Jan has compiled the following financial information as of December 31, 2010.

Revenues during 2010—camping fees	$140,000	Market value of equipment	$140,000
Revenues during 2010—general store	50,000	Notes payable	60,000
Accounts payable	11,000	Expenses during 2010	150,000
Cash on hand	23,000	Supplies on hand	2,500
Original cost of equipment	105,500		

Instructions
(a) Determine Jan Nab's net income from Deer Park for 2010.
(b) Prepare a balance sheet for Deer Park as of December 31, 2010.

Prepare an income statement.
(SO 8)

E1-15 Presented below is financial information related to the 2010 operations of Summers Cruise Company.

Maintenance expense	$ 95,000
Property tax expense (on dock facilities)	10,000
Salaries expense	142,000
Advertising expense	3,500
Ticket revenue	325,000

Instructions
Prepare the 2010 income statement for Summers Cruise Company.

Prepare an owner's equity statement.
(SO 8)

E1-16 Presented below is information related to the sole proprietorship of Kevin Johnson, attorney.

Legal service revenue—2010	$350,000
Total expenses—2010	211,000
Assets, January 1, 2010	85,000
Liabilities, January 1, 2010	62,000
Assets, December 31, 2010	168,000
Liabilities, December 31, 2010	85,000
Drawings—2010	?

Instructions
Prepare the 2010 owner's equity statement for Kevin Johnson's legal practice.

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EXERCISES: SET B

Visit the book's companion website at **www.wiley.com/college/weygandt,** and choose the Student Companion site, to access Exercise Set B.

PROBLEMS: SET A

Analyze transactions and compute net income.

(SO 6, 7)

P1-1A Barone's Repair Shop was started on May 1 by Nancy Barone. A summary of May transactions is presented below.

1. Invested $10,000 cash to start the repair shop.
2. Purchased equipment for $5,000 cash.
3. Paid $400 cash for May office rent.
4. Paid $500 cash for supplies.
5. Incurred $250 of advertising costs in the *Beacon News* on account.
6. Received $5,100 in cash from customers for repair service.
7. Withdrew $1,000 cash for personal use.
8. Paid part-time employee salaries $2,000.
9. Paid utility bills $140.
10. Provided repair service on account to customers $750.
11. Collected cash of $120 for services billed in transaction (10).

Instructions

(a) Prepare a tabular analysis of the transactions, using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, N. Barone, Capital; N. Barone, Drawings; Revenues, and Expenses.

(a) Total assets $12,310

(b) From an analysis of the owner's equity columns, compute the net income or net loss for May.

(b) Net income $3,060

Analyze transactions and prepare income statement, owner's equity statement, and balance sheet.

(SO 6, 7, 8)

P1-2A Maria Gonzalez opened a veterinary business in Nashville, Tennessee, on August 1. On August 31, the balance sheet showed Cash $9,000, Accounts Receivable $1,700, Supplies $600, Office Equipment $6,000, Accounts Payable $3,600, and M. Gonzalez, Capital $13,700. During September the following transactions occurred.

1. Paid $2,900 cash on accounts payable.
2. Collected $1,300 of accounts receivable.
3. Purchased additional office equipment for $2,100, paying $800 in cash and the balance on account.
4. Earned revenue of $8,000, of which $2,500 is paid in cash and the balance is due in October.
5. Withdrew $1,000 cash for personal use.
6. Paid salaries $1,700, rent for September $900, and advertising expense $300.
7. Incurred utilities expense for month on account $170.
8. Received $10,000 from Capital Bank–money borrowed on a note payable.

Instructions

(a) Prepare a tabular analysis of the September transactions beginning with August 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + M. Gonzalez, Capital − M. Gonzalez, Drawings + Revenues − Expenses.

(a) Total assets $29,800

(b) Prepare an income statement for September, an owner's equity statement for September, and a balance sheet at September 30.

(b) Net income $4,930
Ending capital $17,630

Prepare income statement, owner's equity statement, and balance sheet.

(SO 8)

P1-3A On May 1, Jeff Wilkins started Skyline Flying School, a company that provides flying lessons, by investing $45,000 cash in the business. Following are the assets and liabilities of the company on May 31, 2010, and the revenues and expenses for the month of May.

Cash	$ 5,600	Notes Payable	$30,000
Accounts Receivable	7,200	Rent Expense	1,200
Equipment	64,000	Repair Expense	400
Lesson Revenue	7,500	Fuel Expense	2,500
Advertising Expense	500	Insurance Expense	400
		Accounts Payable	800

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Jeff Wilkins made no additional investment in May, but he withdrew $1,500 in cash for personal use.

Instructions

(a) Net income $2,500
Owner's equity $46,000
Total assets $76,800
(b) Net income $1,900
Owner's equity $45,400

(a) Prepare an income statement and owner's equity statement for the month of May and a balance sheet at May 31.

(b) Prepare an income statement and owner's equity statement for May assuming the following data are not included above: (1) $900 of revenue was earned and billed but not collected at May 31, and (2) $1,500 of fuel expense was incurred but not paid.

Analyze transactions and prepare financial statements.
(SO 6, 7, 8)

P1-4A Mark Miller started his own delivery service, Miller Deliveries, on June 1, 2010. The following transactions occurred during the month of June.

June 1 Mark invested $10,000 cash in the business.
2 Purchased a used van for deliveries for $12,000. Mark paid $2,000 cash and signed a note payable for the remaining balance.
3 Paid $500 for office rent for the month.
5 Performed $4,400 of services on account.
9 Withdrew $200 cash for personal use.
12 Purchased supplies for $150 on account.
15 Received a cash payment of $1,250 for services provided on June 5.
17 Purchased gasoline for $100 on account.
20 Received a cash payment of $1,500 for services provided.
23 Made a cash payment of $500 on the note payable.
26 Paid $250 for utilities.
29 Paid for the gasoline purchased on account on June 17.
30 Paid $1,000 for employee salaries.

Instructions

(a) Total assets $23,500

(a) Show the effects of the previous transactions on the accounting equation using the following format.

	Assets					Liabilities			Owner's Equity						
Date	Cash	+	Accounts Receivable	+	Supplies	+	Delivery Van	=	Notes Payable	+	Accounts Payable	+	M. Miller, Capital	−	M. Miller, Drawings	+	Revenues	−	Expenses

(b) Net income $4,050
(c) Cash $8,200

(b) Prepare an income statement for the month of June.
(c) Prepare a balance sheet at June 30, 2010.

Determine financial statement amounts and prepare owner's equity statement.
(SO 7, 8)

P1-5A Financial statement information about four different companies is as follows.

	Karma Company	Yates Company	McCain Company	Dench Company
January 1, 2010				
Assets	$ 95,000	$110,000	(g)	$170,000
Liabilities	50,000	(d)	75,000	(j)
Owner's equity	(a)	60,000	45,000	90,000
December 31, 2010				
Assets	(b)	137,000	200,000	(k)
Liabilities	55,000	75,000	(h)	80,000
Owner's equity	60,000	(e)	130,000	170,000
Owner's equity changes in year				
Additional investment	(c)	15,000	10,000	15,000
Drawings	25,000	(f)	14,000	20,000
Total revenues	350,000	420,000	(i)	520,000
Total expenses	320,000	385,000	342,000	(l)

Instructions

(a) Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets − Liabilities = Owner's equity = $45,000.)
(b) Prepare the owner's equity statement for Yates Company.
(c) Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the owner's equity statement to the income statement and balance sheet.

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PROBLEMS: SET B

Analyze transactions and compute net income.

(SO 6, 7)

P1-1B On April 1, Vinnie Venuchi established Vinnie's Travel Agency. The following transactions were completed during the month.

1. Invested $15,000 cash to start the agency.
2. Paid $600 cash for April office rent.
3. Purchased office equipment for $3,000 cash.
4. Incurred $700 of advertising costs in the *Chicago Tribune,* on account.
5. Paid $800 cash for office supplies.
6. Earned $11,000 for services rendered: $3,000 cash is received from customers, and the balance of $8,000 is billed to customers on account.
7. Withdrew $500 cash for personal use.
8. Paid *Chicago Tribune* amount due in transaction (4).
9. Paid employees' salaries $2,200.
10. Received $4,000 in cash from customers who have previously been billed in transaction (6).

Instructions

(a) Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Office Equipment, Accounts Payable, V. Venuchi, Capital; V. Venuchi, Drawings; Revenues, and Expenses.

(a) Total assets $22,000

(b) From an analysis of the owner's equity columns, compute the net income or net loss for April.

(b) Net income $7,500

Analyze transactions and prepare income statement, owner's equity statement, and balance sheet.

(SO 6, 7, 8)

P1-2B Jenny Brown opened a law office, on July 1, 2010. On July 31, the balance sheet showed Cash $5,000, Accounts Receivable $1,500, Supplies $500, Office Equipment $6,000, Accounts Payable $4,200, and Jenny Brown, Capital $8,800. During August the following transactions occurred.

1. Collected $1,200 of accounts receivable.
2. Paid $2,800 cash on accounts payable.
3. Earned revenue of $8,000 of which $3,000 is collected in cash and the balance is due in September.
4. Purchased additional office equipment for $2,000, paying $400 in cash and the balance on account.
5. Paid salaries $2,500, rent for August $900, and advertising expenses $400.
6. Withdrew $700 in cash for personal use.
7. Received $1,500 from Standard Federal Bank—money borrowed on a note payable.
8. Incurred utility expenses for month on account $220.

Instructions

(a) Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + J. Brown, Capital − J. Brown, Drawings + Revenues − Expenses.

(a) Total assets $16,800

(b) Prepare an income statement for August, an owner's equity statement for August, and a balance sheet at August 31.

(b) Net income $3,980
Ending capital $12,080

Prepare income statement, owner's equity statement, and balance sheet.

(SO 8)

P1-3B On June 1, Michelle Sasse started Divine Creations Co., a company that provides craft opportunities, by investing $15,200 cash in the business. Following are the assets and liabilities of the company at June 30 and the revenues and expenses for the month of June.

Cash	$13,750	Notes Payable	$9,000
Accounts Receivable	3,000	Accounts Payable	1,200
Service Revenue	7,000	Supplies Expense	1,600
Craft Supplies	2,000	Gas and Oil Expense	200
Advertising Expense	400	Utilities Expense	150
Equipment	10,000		

Michelle made no additional investment in June, but withdrew $1,300 in cash for personal use during the month.

Instructions

(a) Prepare an income statement and owner's equity statement for the month of June and a balance sheet at June 30, 2010.

(a) Net income $4,650
Owner's equity $18,550
Total assets $28,750

(b) Prepare an income statement and owner's equity statement for June assuming the following data are not included above: (1) $900 of revenue was earned and billed but not collected at June 30, and (2) $150 of gas and oil expense was incurred but not paid.

(b) Net income $5,400
Owner's equity $19,300

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Analyze transactions and prepare financial statements.
(SO 6, 7, 8)

P1-4B Michelle Rodriguez started her own consulting firm, Rodriguez Consulting, on May 1, 2010. The following transactions occurred during the month of May.

May	1	Michelle invested $7,000 cash in the business.
	2	Paid $900 for office rent for the month.
	3	Purchased $600 of supplies on account.
	5	Paid $125 to advertise in the *County News*.
	9	Received $4,000 cash for services provided.
	12	Withdrew $1,000 cash for personal use.
	15	Performed $6,400 of services on account.
	17	Paid $2,500 for employee salaries.
	20	Paid for the supplies purchased on account on May 3.
	23	Received a cash payment of $4,000 for services provided on account on May 15.
	26	Borrowed $5,000 from the bank on a note payable.
	29	Purchased office equipment for $3,100 on account.
	30	Paid $175 for utilities.

Instructions

(a) Total assets $20,800

(a) Show the effects of the previous transactions on the accounting equation using the following format.

	Assets				Liabilities		Owner's Equity			
Date	Cash +	Accounts Receivable +	Supplies +	Office Equipment =	Notes Payable +	Accounts Payable +	M. Rodriguez, Capital −	M. Rodriguez, Drawing +	Revenues −	Expenses

(b) Net income $6,700
(c) Cash $14,700

(b) Prepare an income statement for the month of May.
(c) Prepare a balance sheet at May 31, 2010.

Determine financial statement amounts and prepare owner's equity statement.
(SO 7, 8)

P1-5B Financial statement information about four different companies is as follows.

	Donatello Company	Raphael Company	Michelangelo Company	Leonardo Company
January 1, 2010				
Assets	$ 80,000	$90,000	(g)	$150,000
Liabilities	48,000	(d)	80,000	(j)
Owner's equity	(a)	40,000	49,000	90,000
December 31, 2010				
Assets	(b)	112,000	180,000	(k)
Liabilities	60,000	72,000	(h)	100,000
Owner's equity	40,000	(e)	70,000	145,000
Owner's equity changes in year				
Additional investment	(c)	8,000	10,000	15,000
Drawings	15,000	(f)	12,000	10,000
Total revenues	350,000	410,000	(i)	500,000
Total expenses	333,000	385,000	350,000	(l)

Instructions

(a) Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets − Liabilities = Owner's equity = $32,000.)
(b) Prepare the owner's equity statement for Donatello Company.
(c) Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the owner's equity statement to the income statement and balance sheet.

PROBLEMS: SET C

Visit the book's companion website at **www.wiley.com/college/weygandt,** and choose the Student Companion site, to access Problem Set C.

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CONTINUING COOKIE CHRONICLE

CCC1 Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They passed many happy hours mastering every type of cookie imaginable and later creating new recipes that were both healthy and delicious. Now at the start of her second year in college, Natalie is investigating various possibilities for starting her own business as part of the requirements of the entrepreneurship program in which she is enrolled.

A long-time friend insists that Natalie has to somehow include cookies in her business plan. After a series of brainstorming sessions, Natalie settles on the idea of operating a cookie-making school. She will start on a part-time basis and offer her services in people's homes. Now that she has started thinking about it, the possibilities seem endless. During the fall, she will concentrate on holiday cookies. She will offer individual lessons and group sessions (which will probably be more entertainment than education for the participants). Natalie also decides to include children in her target market.

The first difficult decision is coming up with the perfect name for her business. In the end, she settles on "Cookie Creations" and then moves on to more important issues.

*The **Continuing Cookie Chronicle** starts in this chapter and continues in every chapter. You also can find this problem at the book's Student Companion site.*

Instructions

(a) What form of business organization—proprietorship, partnership, or corporation—do you recommend that Natalie use for her business? Discuss the benefits and weaknesses of each form and give the reasons for your choice.

(b) Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?

(c) Identify specific asset, liability, and equity accounts that Cookie Creations will likely use to record its business transactions.

(d) Should Natalie open a separate bank account for the business? Why or why not?

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Financial Reporting Problem: PepsiCo, Inc.

BYP1-1 The actual financial statements of PepsiCo, Inc., as presented in the company's 2007 annual report, are contained in Appendix A (at the back of the textbook).

PEPSICO

Instructions

Refer to Pepsi's financial statements and answer the following questions.

(a) What were Pepsi's total assets at December 29, 2007? At December 30, 2006?

(b) How much cash (and cash equivalents) did Pepsi have on December 29, 2007?

(c) What amount of accounts payable did Pepsi report on December 29, 2007? On December 30, 2006?

(d) What were Pepsi's net sales in 2005? In 2006? In 2007?

(e) What is the amount of the change in Pepsi's net income from 2006 to 2007?

Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

BYP1-2 PepsiCo's financial statements are presented in Appendix A. Financial statements of The Coca-Cola Company are presented in Appendix B.

Instructions

(a) Based on the information contained in these financial statements, determine the following for each company.

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(1) Total assets at December 29, 2007, for Pepsi and for Coca-Cola at December 31, 2007.
(2) Accounts (notes) receivable, net at December 29, 2007, for Pepsi and at December 31, 2007, for Coca-Cola.
(3) Net sales for year ended in 2007.
(4) Net income for year ended in 2007.

(b) What conclusions concerning the two companies can be drawn from these data?

Exploring the Web

BYP1-3 This exercise will familiarize you with skill requirements, job descriptions, and salaries for accounting careers.

Address: www.careers-in-accounting.com, or go to **www.wiley.com/college/weygandt**

Instructions
Go to the site shown above. Answer the following questions.

(a) What are the three broad areas of accounting (from "Skills and Talents Required")?
(b) List eight skills required in accounting.
(c) How do the three accounting areas differ in terms of these eight required skills?
(d) Explain one of the key job functions in accounting.
(e) Based on the *Smart Money* survey, what is the salary range for a junior staff accountant with Deloitte & Touche?

CRITICAL THINKING

Decision Making Across the Organization

BYP1-4 Mary and Jack Gray, local golf stars, opened the Chip-Shot Driving Range on March 1, 2010, by investing $25,000 of their cash savings in the business. A caddy shack was constructed for cash at a cost of $8,000, and $800 was spent on golf balls and golf clubs. The Grays leased five acres of land at a cost of $1,000 per month and paid the first month's rent. During the first month, advertising costs totaled $750, of which $150 was unpaid at March 31, and $400 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, Mary and Jack withdrew a total of $1,000 in cash for personal living expenses. A $100 utility bill was received on March 31 but was not paid. On March 31, the balance in the company's bank account was $18,900.

Mary and Jack thought they had a pretty good first month of operations. But, their estimates of profitability ranged from a loss of $6,100 to net income of $2,450.

Instructions
With the class divided into groups, answer the following.

(a) How could the Grays have concluded that the business operated at a loss of $6,100? Was this a valid basis on which to determine net income?
(b) How could the Grays have concluded that the business operated at a net income of $2,450? (*Hint:* Prepare a balance sheet at March 31.) Was this a valid basis on which to determine net income?
(c) Without preparing an income statement, determine the actual net income for March.
(d) What was the revenue earned in March?

Communication Activity

BYP1-5 Lynn Benedict, the bookkeeper for New York Company, has been trying to get the balance sheet to balance. The company's balance sheet is shown on the next page.

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NEW YORK COMPANY
Balance Sheet
For the Month Ended December 31, 2010

Assets		Liabilities	
Equipment	$25,500	Don Wenger, Capital	$26,000
Cash	9,000	Accounts receivable	(6,000)
Supplies	2,000	Don Wenger, Drawing	(2,000)
Accounts payable	(8,000)	Notes payable	10,500
	$28,500		$28,500

Instructions
Explain to Lynn Benedict in a memo why the original balance sheet is incorrect, and what should be done to correct it.

Ethics Case

BYP1-6 After numerous campus interviews, Steve Baden, a senior at Great Northern College, received two office interview invitations from the Baltimore offices of two large firms. Both firms offered to cover his out-of-pocket expenses (travel, hotel, and meals). He scheduled the interviews for both firms on the same day, one in the morning and one in the afternoon. At the conclusion of each interview, he submitted to both firms his total out-of-pocket expenses for the trip to Baltimore: mileage $112 (280 miles at $0.40), hotel $130, meals $36, parking and tolls $18, for a total of $296. He believes this approach is appropriate. If he had made two trips, his cost would have been two times $296. He is also certain that neither firm knew he had visited the other on that same trip. Within ten days Steve received two checks in the mail, each in the amount of $296.

Instructions
(a) Who are the stakeholders (affected parties) in this situation?
(b) What are the ethical issues in this case?
(c) What would you do in this situation?

"All About You" Activity

BYP1-7 As discussed in the **All About You** feature in this chapter (p. 25), some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity, to being both unethical and illegal attempts to mislead investors and creditors.

Instructions
Provide responses for each of the following questions.
(a) Discuss whether you think each of the following actions (adapted from *www.finaid.org/fafsa/maximize.phtml*) to increase the chances of receiving financial aid is ethical.
  (i) Spend down the student's assets and income first, before spending parents' assets and income.
  (ii) Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
  (iii) State that a truly financially dependent child is independent.
  (iv) Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.
(b) What are some reasons why a *company* might want to overstate its earnings?
(c) What are some reasons why a *company* might want to understate its earnings?
(d) Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

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Answers to Insight and Accounting Across the Organization Questions

p. 11 How Will Accounting Help Me?

Q: How might accounting help you?

A: *You will need to understand financial reports in any enterprise with which you are associated. Whether you become a business manager, doctor, lawyer, social worker, teacher, engineer, architect, or entrepreneur, a working knowledge of accounting is relevant.*

p. 23 What Do General Mills, Walt Disney, and Dunkin' Donuts Have in Common?

Q: What year-end would you likely use if you owned a ski resort and ski rental business?

A: *Probable choices for a ski resort would be between May 31 and August 31.*

Q: What if you owned a college bookstore?

A: *For a college bookstore, a likely year-end would be June 30.*

Q: Why choose those year-ends?

A: *The optimum accounting year-end, especially for seasonal businesses, is a point when inventory and activities are lowest.*

Authors' Comments on *All About You: Ethics: Managing Personal Financial Reporting* (p. 25)

In this chapter you saw that there are very specific rules governing the recording of assets, liabilities, revenues, and expenses. However, within these rules there is a lot of room for judgment. It would not be at all unusual for two experienced accountants, when faced with identical situations, to arrive at different results.

Similarly, in reporting your financial situation for financial aid there is a lot of room for judgment. The question is, what kinds of actions are both permissible and ethical, and what kinds of actions are illegal and unethical? It might be argued that paying off your credit card debt to reduce your assets is legal and ethical. It is true that you have intentionally changed the nature of your assets in order to improve your chances of getting aid. You did so, however, through a legitimate transaction. In fact, given the high interest rates charged on credit card bills, it would probably be a good idea to use the cash to pay off your bills even if you aren't applying for aid.

Now, consider an alternative situation. Suppose that you have $10,000 in cash, and you have a sibling who is five years younger than you. Should you "give" the cash to your sibling while you are being considered for financial aid? This would give the appearance of substantially reducing your assets, and thus increase the likelihood that you will receive aid. Most people would argue that this is unethical, and it is probably illegal.

When completing your FAFSA form, don't ignore the following warning on the front of the form: "If you get Federal student aid based on incorrect information, you will have to pay it back; you may also have to pay fines and fees. If you purposely give false or misleading information on your application, you may be fined $20,000, sent to prison, or both."

Answers to Self-Study Questions

1. b **2.** d **3.** c **4.** b **5.** b **6.** d **7.** b **8.** a **9.** b **10.** a **11.** d **12.** c **13.** b **14.** c ***15.** a

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.