CHAPTER 1

An Introduction to Accounting

LEARNING OBJECTIVES

After you have mastered the material in this chapter, you will be able to:

1. Explain the role of accounting in society.
2. Construct an accounting equation using elements of financial statements terminology.
3. Record business events in general ledger accounts organized under an accounting equation.
4. Classify business events as asset source, use, or exchange transactions.
5. Use general ledger account information to prepare four financial statements.
6. Record business events using a horizontal financial statements model.

CHAPTER OPENING

Why should you study accounting? You should study accounting because it can help you succeed in business. Businesses use accounting to keep score. Imagine trying to play football without knowing how many points a touchdown is worth. Like sports, business is competitive. If you do not know how to keep score, you are not likely to succeed.

Accounting is an information system that reports on the economic activities and financial condition of a business or other organization. Do not underestimate the importance of accounting information. If you had information that enabled you to predict business success, you could become a very wealthy Wall Street investor. Communicating economic information is so important that accounting is frequently called the *language of business*.

The Curious Accountant

Who owns **Starbucks**? Who owns the **American Cancer Society** (ACS)? Many people and organizations other than owners are interested in the operations of Starbucks and the ACS. These parties are called *stakeholders*. Among others, they include lenders, employees, suppliers, customers, benefactors, research institutions, local governments, cancer patients, lawyers, bankers, financial analysts, and government agencies such as the Internal Revenue Service and the Securities and Exchange Commission. Organizations communicate information to stakeholders through *financial reports*.

How do you think the financial reports of Starbucks differ from those of the ACS? (Answer on page 11.)

ROLE OF ACCOUNTING IN SOCIETY

LO 1

Explain the role of accounting in society.

How should society allocate its resources? Should we spend more to harvest food or cure disease? Should we build computers or cars? Should we invest money in IBM or General Motors? Accounting provides information that helps answer such questions.

Using Free Markets to Set Resource Priorities

Suppose you want to start a business. You may have heard "you have to have money to make money." In fact, you will need more than just money to start and operate a business. You will likely need such resources as equipment, land, materials, and employees. If you do not have these resources, how can you get them? In the United States, you compete for resources in open markets.

A **market** is a group of people or entities organized to exchange items of value. The market for business resources involves three distinct participants: consumers, conversion agents, and resource owners. *Consumers* use resources. Resources are frequently not in a form consumers want. For example, nature provides trees but consumers want furniture. *Conversion agents* (businesses) transform resources such as trees into desirable products such as furniture. *Resource owners* control the distribution of resources to conversion agents. Thus resource owners provide resources (inputs) to conversion agents who provide goods and services (outputs) to consumers.

For example, a home builder (conversion agent) transforms labor and materials (inputs) into houses (output) that consumers use. The transformation adds value to the inputs, creating outputs worth more than the sum of the inputs. A house that required $220,000 of materials and labor to build could have a market value of $250,000.

Common terms for the added value created in the transformation process include **profit, income,** or **earnings.** Accountants measure the added value as the difference between the cost of a product or service and the selling price of that product or service. The profit on the house described above is $30,000, the difference between its $220,000 cost and $250,000 market value.

Conversion agents who successfully and efficiently (at low cost) satisfy consumer preferences are rewarded with high earnings. These earnings are shared with resource owners, so conversion agents who exhibit high earnings potential are more likely to compete successfully for resources.

Return to the original question. How can you get the resources you need to start a business? You must go to open markets and convince resource owners that you can produce profits. Exhibit 1.1 illustrates the market trilogy involved in resource allocation.

The specific resources businesses commonly use to satisfy consumer demand are financial resources, physical resources, and labor resources.

Financial Resources

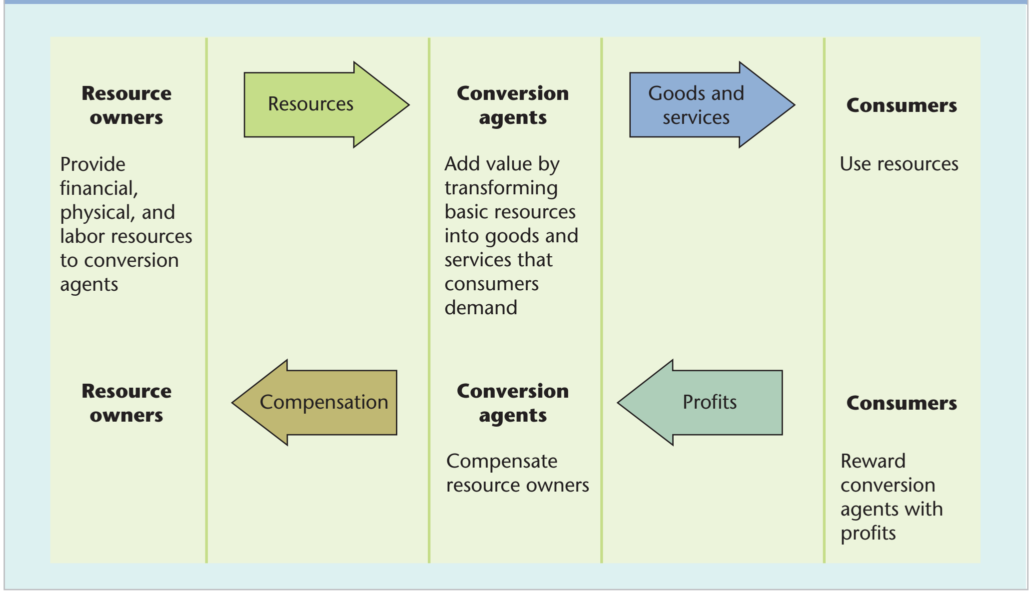
Businesses (conversion agents) need **financial resources** (money) to get started and to operate. *Investors* and *creditors* provide financial resources.

- **Investors** provide financial resources in exchange for ownership interests in businesses. Owners expect businesses to return to them a share of the business income earned.
- **Creditors** lend financial resources to businesses. Instead of a share of business income, creditors expect businesses to repay borrowed resources at a future date.

The resources controlled by a business are called **assets.** If a business ceases to operate, its remaining assets are sold and the sale proceeds are returned to the investors and creditors through a process called business **liquidation.** Creditors have a priority claim on assets in business liquidations. After creditor claims are satisfied, any remaining assets are distributed to investors (owners).

EXHIBIT 1.1

Market Trilogy in Resource Allocation



To illustrate, suppose a business acquired $100 cash from investors and $200 cash from creditors. Assume the business lost $75 and returned the remaining $225 ($300 − $75) to the resource providers. The creditors would receive $200; the owners would receive only $25. If the business lost $120, the creditors would receive only $180 ($300 − $120); the investors would receive nothing.

As this illustration suggests, both creditors and investors can lose resources when businesses fail. Creditors, however, are in a more secure position because of their priority claim on resources. In exchange for their more secure position, creditors normally do not share business profits. Instead, they receive a fixed amount of money called **interest.**

Investors and creditors prefer to provide financial resources to businesses with high earnings potential because such companies are better able to share profits and make interest payments. Profitable businesses are also less likely to experience bankruptcy and liquidation.

Physical Resources

In their most primitive form, **physical resources** are natural resources. Physical resources often move through numerous stages of transformation. For example, standing timber may be successively transformed into harvested logs, raw lumber, and finished furniture. Owners of physical resources seek to sell those resources to businesses with high earnings potential because profitable businesses are able to pay higher prices and make repeat purchases.

Labor Resources

Labor resources include both intellectual and physical labor. Like other resource providers, workers prefer businesses that have high income potential because these businesses are able to pay higher wages and offer continued employment.

Accounting Provides Information

How do providers of financial, physical, and labor resources identify conversion agents (businesses) with high profit potential? Investors, creditors, and workers rely heavily on accounting information to evaluate which businesses are worthy of receiving resources. In addition, other people and organizations have an interest in accounting information about businesses. The many **users** of accounting information are commonly called **stakeholders.** Stakeholders include resource providers, financial analysts, brokers, attorneys, government regulators, and news reporters.

The link between conversion agents (businesses) and those stakeholders who provide resources is direct: businesses pay resource providers. Resource providers use accounting information to identify companies with high earnings potential because those companies are more likely to return higher profits, make interest payments, repay debt, pay higher prices, and provide stable employment.

The link between conversion agents and other stakeholders is indirect. Financial analysts, brokers, and attorneys may use accounting information when advising their clients. Government agencies may use accounting information to assess companies' compliance with income tax laws and other regulations. Reporters may use accounting information in news reports.

Types of Accounting Information

Stakeholders such as investors, creditors, lawyers, and financial analysts exist outside of and separate from the businesses in which they are interested. The accounting information these *external users* need is provided by **financial accounting.** In contrast, the accounting information needed by *internal users,* stakeholders such as managers and employees who work within a business, is provided by **managerial accounting.**

The information needs of external and internal users frequently overlap. For example, external and internal users are both interested in the amount of income a business earns. Managerial accounting information, however, is usually more detailed than financial accounting reports. Investors are concerned about the overall profitability of **Wendy's** versus **Burger King**; a Wendy's regional manager is interested in the profits of individual Wendy's restaurants. In fact, a regional manager is also interested in nonfinancial measures, such as the number of employees needed to operate a restaurant, the times at which customer demand is high versus low, and measures of cleanliness and customer satisfaction.

Nonbusiness Resource Usage

The U.S. economy is not *purely* market based. Factors other than profitability often influence resource allocation priorities. For example, governments allocate resources to national defense, to redistribute wealth, or to protect the environment. Foundations, religious groups, the **Peace Corps**, and other benevolent organizations prioritize resource usage based on humanitarian concerns.

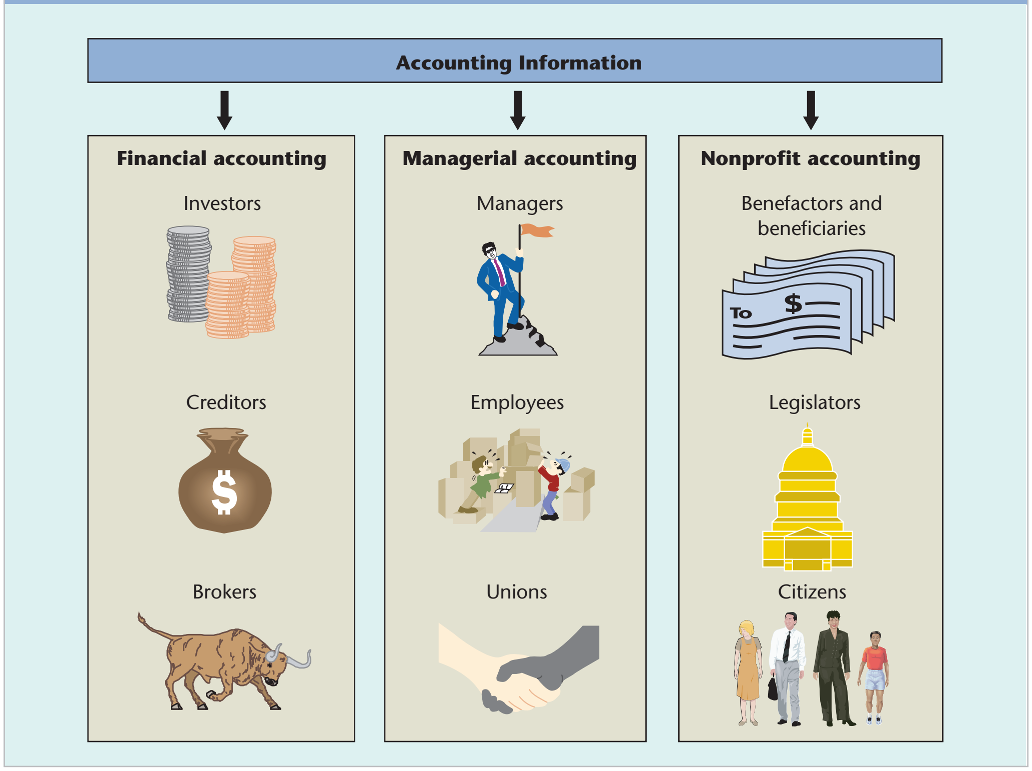
Like profit-oriented businesses, civic or humanitarian organizations add value through resource transformation. For example, a soup kitchen adds value to uncooked meats and vegetables by converting them into prepared meals. The individuals who consume the meals, however, are unable to pay for the kitchen's operating costs, much less for the added value. The soup kitchen's motivation is to meet humanitarian needs, not to earn profits. Organizations that are not motivated by profit are called **not-for-profit entities** (also called *nonprofit* or *nonbusiness organizations*).

Stakeholders interested in nonprofit organizations also need accounting information. Accounting systems measure the cost of the goods and services not-for-profit organizations provide, the efficiency and effectiveness of the organizations' operations, and the ability of the organizations to continue to provide goods and services. This information serves a host of stakeholders, including taxpayers, contributors, lenders, suppliers, employees, managers, financial analysts, attorneys, and beneficiaries.

The focus of accounting, therefore, is to provide information useful to making decisions for a variety of business and nonbusiness user groups. The different types of accounting information and the stakeholders that commonly use the information are summarized in Exhibit 1.2.

EXHIBIT 1.2

Accounting as Information Provider



Careers in Accounting

An accounting career can take you to the top of the business world. *BusinessWeek* studied the backgrounds of the chief executive officers (CEOs) of the 1,000 largest public corporations. More CEOs had backgrounds in finance and accounting than any other field. Exhibit 1.3 provides additional detail regarding the career paths followed by these executives.

What do accountants do? Accountants identify, record, analyze, and communicate information about the economic events that affect organizations. They may work in either public accounting or private accounting.

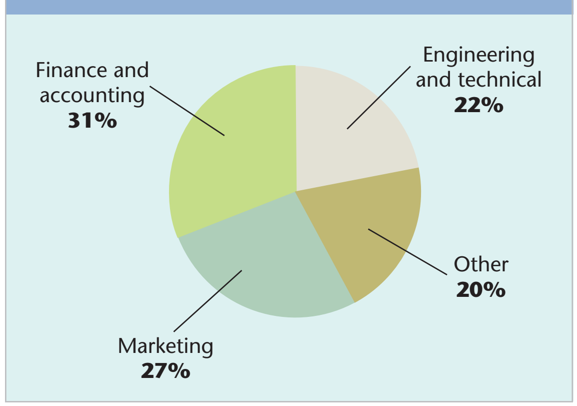
Public Accounting

You are probably familiar with the acronym CPA. CPA stands for certified *public* accountant. Public accountants provide services to various clients. They are usually paid a fee that varies depending on the service provided. Services typically offered by public accountants include (1) audit services, (2) tax services, and (3) consulting services.

- *Audit services* involve examining a company's accounting records in order to issue an opinion about whether the company's financial statements conform to generally accepted accounting principles. The auditor's opinion adds credibility to the statements, which are prepared by the company's management.
- *Tax services* include both determining the amount of tax due and tax planning to help companies minimize tax expense.
- *Consulting services* cover a wide range of activities that includes everything from installing sophisticated computerized accounting systems to providing personal financial advice.

EXHIBIT 1.3

Career Paths of Chief Executive Officers



All public accountants are not certified. Each state government establishes certification requirements applicable in that state. Although the requirements vary from state to state, CPA candidates normally must have a college education, pass a demanding technical examination, and obtain work experience relevant to practicing public accounting.

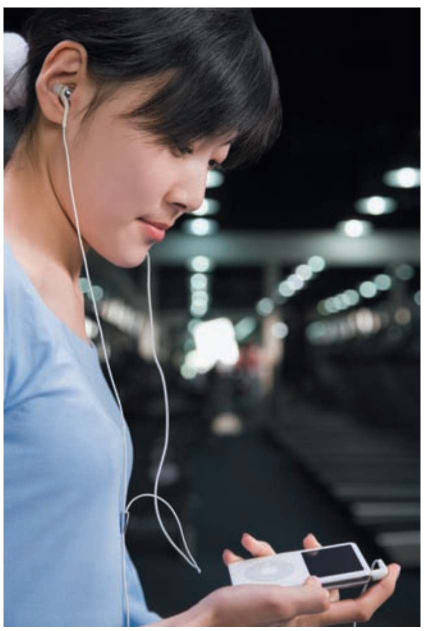
Private Accounting

Accountants employed in the private sector usually work for a specific company or nonprofit organization. Private sector accountants perform a wide variety of functions for their employers. Their duties include classifying and recording transactions, billing customers and collecting amounts due, ordering merchandise, paying suppliers, preparing and analyzing financial statements, developing budgets, measuring costs, assessing performance, and making decisions.

Private accountants may earn any of several professional certifications. For example, the Institute of Certified Management Accountants issues the *Certified Management Accounting (CMA)* designation. The Institute of Internal Auditors issues the *Certified Internal Auditor (CIA)* designation. These designations are widely recognized indicators of technical competence and integrity on the part of individuals who hold them. All professional accounting certifications call for meeting education requirements, passing a technical examination, and obtaining relevant work experience.

Measurement Rules

Suppose a store sells a MP3 player in December to a customer who agrees to pay for it in January. Should the business *recognize* (report) the sale as a December transaction or as a January transaction? It really does not matter as long as the storeowner discloses the rule the decision is based on and applies it consistently to other transactions. Because businesses may use different reporting rules, however, clear communication also requires full and fair disclosure of the accounting rules chosen.



Communicating business results would be simpler if each type of business activity were reported using only one measurement method. World economies and financial reporting practices, however, have not evolved uniformly. Even in highly sophisticated countries such as the United States, companies exhibit significant diversity in reporting methods. Providers of accounting reports assume that users are educated about accounting practices.

The **Financial Accounting Standards Board (FASB)**[1] is a privately funded organization with the primary authority for establishing accounting standards in the United States. The measurement rules established by the FASB are called **generally accepted accounting principles (GAAP).** Financial reports issued to the public must follow GAAP. This textbook introduces these principles so you will be able to understand business activity reported by companies in the USA.

Companies are not required to follow GAAP when preparing *management accounting* reports. Although there is considerable overlap between financial and managerial accounting, managers are free to construct internal reports in whatever fashion best suits the effective operation of their companies.

[1]The FASB consists of seven full-time members appointed by the supporting organization, the Financial Accounting Foundation (FAF). The FAF membership is intended to represent the broad spectrum of individuals and institutions that have an interest in accounting and financial reporting. FAF members include representatives of the accounting profession, industry, financial institutions, the government, and the investing public.

FOCUS ON INTERNATIONAL ISSUES

IS THERE GLOBAL GAAP?

As explained in this chapter, accounting is a measurement and communication discipline based on rules referred to as *generally accepted accounting principles (GAAP)*. The rules described in this text are based on GAAP used in the United States, but what rules do the rest of the world use? Is there a global GAAP, or does each country establish its own unique GAAP?

Not long ago each country developed its own unique GAAP. Global companies were required to prepare multiple sets of financial statements to satisfy each country's GAAP. The use of multiple accounting standards across the globe made comparing company performance difficult and expensive. To address the need for a common set of financial standards, the International Accounting Standards Committee was formed in 1973. The committee was reorganized as the **International Accounting Standards Board (IASB)** in 2001. The IASB issues **International Financial Reporting Standards (IFRS),** which are rapidly gaining support worldwide. In 2005, companies in the countries who were members of the European Union were required to use the IFRS as established by the IASB, which is headquartered in London. Today, over 100 countries require or permit companies to prepare their financial statements using IFRS.

As of 2009 most of the major economic countries had either switched from their local GAAP to IFRS, or had rules in place to make the switch by 2012. One notable exception is the United States, but even here, the Securities and Exchange Commission announced in 2008 that it was seriously considering adopting rules that would allow U.S. companies to use either GAAP or IFRS. Although not finalized when this book was being prepared, many accountants in the United States believe this will occur. Additionally, there is an active process in place to reduce the differences between IFRS and U.S. GAAP.

There are many similarities between the IASB and the FASB. Both the FASB and the IASB are required to include members with a variety of backgrounds, including auditors, users of financial information, academics, and so forth. Also, both groups primarily require that their members work full-time for their respective boards; they cannot serve on the board while being compensated by another organization. (The IASB does allow up to three of its members to be part-time.) Members of each board serve five-year terms, and can be reappointed once. The funds to support both boards, and the large organizations that support them are obtained from a variety of sources, including selling publications and private contributions. To help maintain independence of the boards' members, fundraising is performed by separate sets of trustees.

There are significant differences between the IASB and the FASB, and one of these relates to size and geographic diversity. The FASB has only seven members, all from the United States. The IASB has fourteen members, and these must include at least four from Asia, four from Europe, four from North America, one from Africa, and one from South America.

Not only is the structure of the standards-setting boards different but the standards and principles they establish may also differ significantly. In this chapter, you will learn that GAAP employs the *historical cost concept.* This means that the assets of most U.S. companies are shown on the balance sheet at the amount for which they were purchased. For example, land owned by U.S. Steel, Inc., that has a market value of millions of dollars may be shown on US Steel's financial statements with a value of only a few hundred thousand dollars. This occurs because GAAP requires US Steel to show the land at its cost rather than its market value. In contrast, IFRS permits companies to show market values on their financial statements. This means that the exact same assets may show radically different values if the statements are prepared under IFRS rather than GAAP.

Throughout this text, where appropriate, we will note the differences between U.S. GAAP and IFRS. However, by the time you graduate, it is likely that among the major industrialized nations, there will be a global GAAP.

Reporting Entities

Think of accountants as you would of news reporters. A news reporter gathers and discloses information about some person, place, or thing. Likewise, an accountant gathers and discloses financial information about specific people or businesses. The people or businesses accountants report on are called **reporting entities.** When studying accounting you should think of yourself as an accountant. Your first step is to identify the person or business on which you are reporting. This is not always as easy as it may seem. To illustrate, consider the following scenario.

Jason Winston recently started a business. During the first few days of operation, Mr. Winston transferred cash from his personal account into a business account for a company he named Winston Enterprises. Mr. Winston's brother, George, invested cash in Winston Enterprises for which he received an ownership interest in the company. Winston Enterprises borrowed cash from First Federal Bank. Winston Enterprises paid cash to purchase a building from Commercial Properties, Inc. Winston Enterprises earned cash revenues from its customers and paid its employees cash for salaries expense.

How many reporting entities are described in this scenario? Assuming all of the customers are counted as a single entity and all of the employees are counted as a single entity, there are a total of seven entities named in the scenario. These entities include: (1) Jason Winston, (2) Winston Enterprises (3) George Winston, (4) First Federal Bank, (5) Commercial Properties, Inc., (6) the customers, and (7) the employees. A separate set of accounting records would be maintained for each entity.

Your ability to learn accounting will be greatly influenced by how you approach the entity concept. Based on your everyday experiences you likely think from the perspective of a customer. In contrast, this text is written from the perspective of a business entity. These opposing perspectives dramatically affect how you view business events. For example, as a customer you consider a sales discount a great bargain. The view is different from the perspective of the business granting the discount. A sales discount means an item did not sell at the expected price. To move the item, the business had to accept less money than it originally planned to receive. From this perspective, a sales discount is not a good thing. To understand accounting, train yourself to interpret transactions from the perspective of a business rather than a consumer. Each time you encounter an accounting event ask yourself, how does this affect the business?

CHECK YOURSELF 1.1

In a recent business transaction, land was exchanged for cash. Did the amount of cash increase or decrease?

Answer The answer depends on the reporting entity to which the question pertains. One entity sold land. The other entity bought land. For the entity that sold land, cash increased. For the entity that bought land, cash decreased.

ELEMENTS OF FINANCIAL STATEMENTS

LO 2

Construct an accounting equation using elements of financial statements terminology.

The individuals and organizations that need information about a business are called *stakeholders.* Stakeholders include owners, lenders, government agencies, employees, news reporters, and others. Businesses communicate information to stakeholders through four financial statements:[2] (1) an income statement, (2) a statement of changes in equity, (3) a balance sheet, and (4) a statement of cash flows.

The information reported in **financial statements** is organized into ten categories known as **elements.** Eight financial statement elements are discussed in this chapter: assets, liabilities, equity, contributed capital, revenue, expenses, distributions, and net income. The other two elements, gains and losses, are discussed in a later chapter. In practice, the business world uses various titles to identify several of the financial statement elements. For example, business people use net income, net *earnings,* and net *profit* interchangeably to describe the same element. Contributed capital may be called *common stock* and equity

[2]In practice these statements have alternate names. For example, the income statement may be called *results of operations* or *statement of earnings.* The balance sheet is sometimes called the *statement of financial position.* The statement of changes in equity might be called *statement of capital* or *statement of stockholders' equity.* Since the Financial Accounting Standards Board (FASB) called for the title *statement of cash flows,* companies do not use alternate names for that statement.

Answers to The Curious Accountant

Anyone who owns stock in **Starbucks** owns a part of the company. Starbucks has many owners. In contrast, nobody actually owns the **American Cancer Society** (ACS). The ACS has a board of directors that is responsible for overseeing its operations, but the board is not its owner.

Ultimately, the purpose of a business entity is to increase the wealth of its owners. To this end, it "spends money to make money." The expense that Starbucks incurs for advertising is a cost incurred in the hope that it will generate revenues when it sells coffee. The financial statements of a business show, among other things, whether and how the company made a profit during the current year. For example, Starbucks' income statements show how much revenue was generated from "company-owned retail"operations versus from "licensing operations."

The ACS is a not-for-profit entity. It operates to provide services to society at large, not to make a profit. It cannot increase the wealth of its owners, because it has no owners. When the ACS spends money to assist cancer patients, it does not spend this money in the expectation that it will generate revenues. The revenues of the ACS come from contributors who wish to support efforts related to fighting cancer. Because the ACS does not spend money to make money, it has no reason to prepare an *income statement* like that of Starbucks. The ACS's statement of activities shows how much revenue was received from "contributions" versus from "special events."

Not-for-profit entities do prepare financial statements that are similar in appearance to those of commercial enterprises. The financial statements of not-for-profit entities are called the *statement of financial position,* the *statement of activities,* and the *cash flow statement.*

may be called *stockholders' equity, owner's capital,* and *partners' equity.* Furthermore, the transfer of assets from a business to its owners may be called *distributions, withdrawals,* or *dividends.* Think of accounting as a language. Different terms can describe the same business event. Detailed definitions of the elements and their placement on financial statements will be discussed in the following sections of the chapter.

Using Accounts to Gather Information

Detailed information about the elements is maintained in records commonly called **accounts.** For example, information regarding the element *assets* may be organized in separate accounts for cash, equipment, buildings, land, and so forth. The types and number of accounts used by a business depends on the information needs of its stakeholders. Some businesses provide very detailed information; others report highly summarized information. The more detail desired, the greater number of accounts needed. Think of accounts like the notebooks students keep for their classes. Some students keep detailed notes about every class they take in a separate notebook. Other students keep only the key points for all of their classes in a single notebook. Similarly, some businesses use more accounts than other businesses.

Diversity also exists regarding the names used for various accounts. For example, employee pay may be called salaries, wages, commissions, and so forth. Do not become frustrated with the diversity of terms used in accounting. Remember, accounting is a language. The same word can have different meanings. Similarly, different words can be used to describe the same phenomenon. The more you study and use accounting, the more familiar it will become to you.

Accounting Equation

The resources that a business uses to produce earnings are called *assets.* Examples of assets include land, buildings, equipment, materials, and supplies. Assets result from historical events. For example, if a business owns a truck that it purchased in a past transaction, the truck is an asset of the business. A truck that a business *plans* to purchase in the future, however, is not an asset of that business, no matter how certain the future purchase might be.

The resource providers (creditors and investors) have potential **claims**[3] on the assets owned by a business. The relationship between the assets and the providers' claims is described by the **accounting equation:**

$$\text{Assets} = \text{Claims}$$

Creditor claims are called **liabilities** and investor claims are called **equity.** Substituting these terms into the accounting equation produces the following expanded form:

$$\text{Assets} = \overbrace{\text{Liabilities} + \text{Equity}}^{\text{Claims}}$$

Liabilities can also be viewed as future *obligations of the enterprise.* To settle the obligations, the business will probably either relinquish some of its assets (e.g., pay off its debts with cash), provide services to its creditors (e.g., work off its debts), or accept other obligations (e.g., trade short-term debt for long-term debt).

As indicated by the accounting equation, the amount of total assets is equal to the total of the liabilities plus the equity. To illustrate, assume that Hagan Company has assets of \$500, liabilities of \$200, and equity of \$300. These amounts appear in the accounting equation as follows:

$$\begin{array}{ccccc} & & \multicolumn{3}{c}{\overbrace{\hphantom{\text{Liabilities} + \text{Equity}}}^{\text{Claims}}} \\ \text{Assets} & = & \text{Liabilities} & + & \text{Equity} \\ \$500 & = & \$200 & + & \$300 \end{array}$$

The claims side of the accounting equation (liabilities plus equity) may also be viewed as listing the sources of the assets. For example, when a bank loans assets (money) to a business, it establishes a claim to have those assets returned at some future date. Liabilities can therefore be viewed as sources of assets.

Equity can also be viewed as a source of assets. In fact, equity represents two distinct sources of assets. First, businesses typically acquire assets from their owners (investors). Many businesses issue **common stock**[4] certificates as receipts to acknowledge assets received from owners. The owners of such businesses are often called **stockholders,** and the ownership interest in the business is called **stockholders' equity.**

Second, businesses usually obtain assets through their earnings activities (the business acquires assets by working for them). Assets a business has earned can either be distributed to the owners or kept in the business. The portion of assets that has been provided by earnings activities and not returned as dividends is called **retained earnings.** Since stockholders own the business, they are entitled to assets acquired through its earnings activities. Retained earnings is therefore a component of stockholders' equity. Further

[3]A claim is a legal action to obtain money, property, or the enforcement of a right against another party.

[4]This presentation assumes the business is organized as a corporation. Other forms of business organization include proprietorships and partnerships. The treatment of equity for these types of businesses is slightly different from that of corporations. A detailed discussion of the differences is included in a later chapter of the text.

expansion of the accounting equation can show the three sources of assets (liabilities, common stock, and retained earnings):

$$\text{Assets} = \text{Liabilities} + \overbrace{\text{Common stock} + \text{Retained earnings}}^{\text{Stockholders' equity}}$$

CHECK YOURSELF 1.2

Gupta Company has $250,000 of assets, $60,000 of liabilities, and $90,000 of common stock. What percentage of the assets was provided by retained earnings?

Answer First, using algebra, determine the dollar amount of retained earnings:

Assets = Liabilities + Common stock + Retained earnings
Retained earnings = Assets − Liabilities − Common stock
Retained earnings = $250,000 − $60,000 − $90,000
Retained earnings = $100,000

Second, determine the percentage:

Percentage of assets provided by retained earnings = Retained earnings/Total assets
Percentage of assets provided by retained earnings = $100,000/$250,000 = 40%

RECORDING BUSINESS EVENTS UNDER THE ACCOUNTING EQUATION

An **accounting event** is an economic occurrence that changes an enterprise's assets, liabilities, or stockholders' equity. A **transaction** is a particular kind of event that involves transferring something of value between two entities. Examples of transactions include acquiring assets from owners, borrowing money from creditors, and purchasing or selling goods and services. The following section of the text explains how several different types of accounting events affect a company's accounting equation.

LO 3

Record business events in general ledger accounts organized under an accounting equation.

Asset Source Transactions

As previously mentioned, businesses obtain assets (resources) from three sources. They acquire assets from owners (stockholders); they borrow assets from creditors; and they earn assets through profitable operations. Asset source transactions increase total assets and total claims. A more detailed discussion of the effects of asset source transactions is provided below:

EVENT 1 Rustic Camp Sites (RCS) was formed on January 1, 2012, when it acquired $120,000 cash from issuing common stock.

When RCS issued stock, it received cash and gave each investor (owner) a stock certificate as a receipt. Since this transaction provided $120,000 of assets (cash) to the business, it is an **asset source transaction.** It increases the business's assets (cash) and its stockholders' equity (common stock).

	Assets			=	Liab.	+	Stockholders' Equity		
	Cash	+	**Land**	=	**N. Pay.**	+	**Com. Stk.**	+	**Ret. Earn.**
Acquired cash through stock issue	120,000	+	NA	=	NA	+	120,000	+	NA

Notice the elements have been divided into accounts. For example, the element *assets* is divided into a Cash account and a Land account. Do not be concerned if some of these account titles are unfamiliar. They will be explained as new transactions are presented. Recall that the number of accounts a company uses depends on the nature of its business and the level of detail management needs to operate the business. For example, **Sears** would have an account called Cost of Goods Sold although **GEICO Insurance** would not. Why? Because Sears sells goods (merchandise) but GEICO does not.

Also, notice that a stock issue transaction affects the accounting equation in two places, both under an asset (cash) and also under the source of that asset (common stock). All transactions affect the accounting equation in at least two places. It is from this practice that the **double-entry bookkeeping** system derives its name.

EVENT 2 RCS acquired an additional $400,000 of cash by borrowing from a creditor.

This transaction is also an asset source transaction. It increases assets (cash) and liability claims (notes payable). The account title Notes Payable is used because the borrower (RCS) is required to issue a promissory note to the creditor (a bank). A promissory note describes, among other things, the amount of interest RCS will pay and for how long it will borrow the money.[5] The effect of the borrowing transaction on the accounting equation is indicated below.

	Assets			=	Liab.	+	Stockholders' Equity		
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.
Beginning balances	120,000	+	NA	=	NA	+	120,000	+	NA
Acquired cash by issuing note	400,000	+	NA	=	400,000	+	NA	+	NA
Ending balances	520,000	+	NA	=	400,000	+	120,000	+	NA

The beginning balances above came from the ending balances produced by the prior transaction. This practice is followed throughout the illustration.

Asset Exchange Transactions

Businesses frequently trade one asset for another asset. In such cases, the amount of one asset decreases and the amount of the other asset increases. Total assets are unaffected by asset exchange transactions. Event 3 is an asset exchange transaction.

EVENT 3 RCS paid $500,000 cash to purchase land.

This asset exchange transaction reduces the asset account Cash and increases the asset account Land. The amount of total assets is not affected. An **asset exchange transaction** simply reflects changes in the composition of assets. In this case, the company traded cash for land. The amount of cash decreased by $500,000 and the amount of land increased by the same amount.

	Assets			=	Liab.	+	Stockholders' Equity		
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.
Beginning balances	520,000	+	NA	=	400,000	+	120,000	+	NA
Paid cash to buy land	(500,000)	+	500,000	=	NA	+	NA	+	NA
Ending balances	20,000	+	500,000	=	400,000	+	120,000	+	NA

[5]For simplicity, the effects of interest are ignored in this chapter. We discuss accounting for interest in future chapters.

Another Asset Source Transaction

EVENT 4 RCS obtained $85,000 cash by leasing camp sites to customers.

Revenue represents an economic benefit a company obtains by providing customers with goods and services. In this example the economic benefit is an increase in the asset cash. Revenue transactions can therefore be viewed as *asset source transactions.* The asset increase is balanced by an increase in the retained earnings section of stockholders' equity because producing revenue increases the amount of earnings that can be retained in the business.

	Assets			=	Liab.	+	Stockholders' Equity			
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Acct. Title
Beginning balances	20,000	+	500,000	=	400,000	+	120,000	+	NA	
Acquired cash by earning revenue	85,000	+	NA	=	NA	+	NA	+	85,000	Revenue
Ending balances	105,000	+	500,000	=	400,000	+	120,000	+	85,000	

Note carefully that the $85,000 ending balance in the retained earnings column is *not* in the Retained Earnings account. It is in the Revenue account. It will be transferred to the Retained Earnings account at the end of the accounting period. Transferring the Revenue account balance to the Retained Earnings account is part of a process called *closing the accounts.*

Asset Use Transactions

Businesses use assets for a variety of purposes. For example, assets may be used to pay off liabilities or they may be transferred to owners. Assets may also be used in the process of generating earnings. All **asset use transactions** decrease the total amount of assets and the total amount of claims on assets (liabilities or stockholders' equity).

EVENT 5 RCS paid $50,000 cash for operating expenses such as salaries, rent, and interest. (RCS could establish a separate account for each type of expense. However, the management team does not currently desire this level of detail. Remember, the number of accounts a business uses depends on the level of information managers need to make decisions.)

In the normal course of generating revenue, a business consumes various assets and services. The assets and services consumed to generate revenue are called **expenses.** Revenue results from providing goods and services to customers. In exchange, the business acquires assets from its customers. Since the owners bear the ultimate risk and reap the rewards of operating the business, revenues increase stockholders' equity (retained earnings), and expenses decrease retained earnings. In this case, the asset account, Cash, decreased. This decrease is balanced by a decrease in the retained earnings section of stockholders' equity because expenses decrease the amount of earnings retained in the business.

	Assets			=	Liab.	+	Stockholders' Equity			
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Acct. Title
Beginning balances	105,000	+	500,000	=	400,000	+	120,000	+	85,000	
Used cash to pay expenses	(50,000)	+	NA	=	NA	+	NA	+	(50,000)	Expense
Ending balances	55,000	+	500,000	=	400,000	+	120,000	+	35,000	

Like revenues, expenses are not recorded directly into the Retained Earnings account. The $50,000 of expense is recorded in the Expense account. It will be transferred to the Retained Earnings account at the end of the accounting period as part of the closing process. The $35,000 ending balance in the retained earnings column shows what would be in the Retained Earnings account after the balances in the Revenue and Expense accounts have been closed. The current balance in the Retained Earnings account is zero.

EVENT 6 RCS paid $4,000 in cash dividends to its owners.

To this point the enterprise's total assets and equity have increased by $35,000 ($85,000 of revenue − $50,000 of expense) as a result of its earnings activities. RCS can keep the additional assets in the business or transfer them to the owners. If a business transfers some or all of its earned assets to owners, the transfer is frequently called a **dividend.** Since assets distributed to stockholders are not used for the purpose of generating revenue, *dividends are not expenses.* Furthermore, dividends are a transfer of *earnings,* not a return of the assets acquired from the issue of common stock.

	Assets			=	Liab.	+	Stockholders' Equity			
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Acct. Title
Beginning balances	55,000	+	500,000	=	400,000	+	120,000	+	35,000	
Used cash to pay dividends	(4,000)	+	NA	=	NA	+	NA	+	(4,000)	Dividends
Ending balances	51,000	+	500,000	=	400,000	+	120,000	+	31,000	

Like revenues and expenses, dividends are not recorded directly into the Retained Earnings account. The $4,000 dividend is recorded in the Dividends account. It will be transferred to retained earnings at the end of the accounting period as part of the closing process. The $31,000 ending balance in the retained earnings column shows what would be in the Retained Earnings account after the balances in the Revenue, Expense, and Dividend accounts have been closed. The current balance in the Retained Earnings account is zero.

EVENT 7 The land that RCS paid $500,000 to purchase had an appraised market value of $525,000 on December 31, 2012.

Although the appraised value of the land is higher than the original cost, RCS will not increase the amount recorded in its accounting records above the land's $500,000 historical cost. In general, accountants do not recognize changes in market value. The **historical cost concept** requires that most assets be reported at the amount paid for them (their historical cost) regardless of increases in market value.

Surely investors would rather know what an asset is worth instead of how much it originally cost. So why do accountants maintain records and report financial information based on historical cost? Accountants rely heavily on the **reliability concept.** Information is reliable if it can be independently verified. For example, two people looking at the legal documents associated with RCS's land purchase will both conclude that RCS paid $500,000 for the land. That historical cost is a verifiable fact. The appraised value, in contrast, is an opinion. Even two persons who are experienced appraisers are not likely to come up with the same amount for the land's market value. Accountants do not report market values in financial statements because such values are not reliable.

Accountants recognize the conflict between *relevance* and *reliability*. As a result, there are exceptions to the application of the historical cost rule. When market value can be clearly established, GAAP not only permits but requires its use. For example, securities that are traded on the New York Stock Exchange must be shown at market value rather than historical cost. We will discuss other notable exceptions to the historical cost principle later in the text. However, as a general rule you should assume that assets shown in a company's financial statements are valued at historical cost.

EXHIBIT 1.4

Accounting Events

1. RCS issued common stock, acquiring $120,000 cash from its owners.
2. RCS borrowed $400,000 cash.
3. RCS paid $500,000 cash to purchase land.
4. RCS received $85,000 cash from earning revenue.
5. RCS paid $50,000 cash for expenses.
6. RCS paid dividends of $4,000 cash to the owners.
7. The land that RCS paid $500,000 to purchase had an appraised market value of $525,000 on December 31, 2012.

General Ledger Accounts Organized Under the Accounting Equation

	Assets			=	Liabilities	+	Stockholders' Equity			
Event No.	Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings	Other Account Titles
Beg. bal.	0		0		0		0		0	
1.	120,000						120,000			
2.	400,000				400,000					
3.	(500,000)		500,000							
4.	85,000								85,000	Revenue
5.	(50,000)								(50,000)	Expense
6.	(4,000)								(4,000)	Dividend
7.	NA		NA		NA		NA		NA	
	51,000	+	500,000	=	400,000	+	120,000	+	31,000	

Summary of Transactions

The complete collection of a company's accounts is called the **general ledger.** A summary of the accounting events and the general ledger account information for RCS's 2012 accounting period is shown in Exhibit 1.4. The revenue, expense, and dividend account data appear in the retained earnings column. These account titles are shown immediately to the right of the dollar amounts listed in the retained earnings column.

RECAP: TYPES OF TRANSACTIONS

LO 4

Classify business events as asset source, use, or exchange transactions.

The transactions described above have each been classified into one of three categories: (1) asset source transactions; (2) asset exchange transactions; and (3) asset use transactions. A fourth category, claims exchange transactions, is introduced in a later chapter. In summary

- ***Asset source transactions*** increase the total amount of assets and increase the total amount of claims. In its first year of operation, RCS acquired assets from three sources: first, from owners (Event 1); next, by borrowing (Event 2); and finally, through earnings activities (Event 4).
- ***Asset exchange transactions*** decrease one asset and increase another asset. The total amount of assets is unchanged by asset exchange transactions. RCS experienced one asset exchange transaction; it used cash to purchase land (Event 3).
- ***Asset use transactions*** decrease the total amount of assets and the total amount of claims. RCS used assets to pay expenses (Event 5) and to pay dividends (Event 6).

As you proceed through this text, practice classifying transactions into one of the four categories. Businesses engage in thousands of transactions every day. It is far more effective to learn how to classify the transactions into meaningful categories than to attempt to memorize the effects of thousands of transactions.

PREPARING FINANCIAL STATEMENTS

LO 5

Use general ledger account information to prepare four financial statements.

As indicated earlier, accounting information is normally presented to external users in four general-purpose financial statements. The information in the ledger accounts is used to prepare these financial statements. The data in the ledger accounts in Exhibit 1.4 are color coded to help you understand the source of information in the financial statements. The numbers in *green* are used in the *statement of cash flows.* The numbers in *red* are used to prepare the *balance sheet.* Finally, the numbers in *blue* are used to prepare the *income statement.* The numbers reported in the statement of changes in stockholders' equity have not been color coded because they appear in more than one statement. The next section explains how the information in the accounts is presented in financial statements.

The financial statements for RCS are shown in Exhibit 1.5. The information used to prepare these statements was drawn from the ledger accounts. Information in one statement may relate to information in another statement. For example, the amount of net income reported on the income statement also appears on the statement of changes in stockholders' equity. Accountants use the term **articulation** to describe the interrelationships among the various elements of the financial statements. The key articulated relationships in RCS's financial statements are highlighted with arrows (Exhibit 1.5). A description of each statement follows.

Income Statement and the Matching Concept

A business must make sacrifices in order to obtain benefits. For example, RCS must sacrifice cash to pay for employee salaries, rent, and interest. In turn, RCS receives a benefit when it collects cash from its customers. As this example implies, sacrifices are defined as decreases in assets; and benefits are increases in assets. In accounting terms sacrifices are called expenses; and benefits are called revenues. *Therefore, expenses are decreases in assets; and revenues are increases in assets.*[6]

The **income statement** matches the expenses with the revenues that occur when operating a business. If revenues exceed expenses, the difference is called **net income.** If expenses are greater than revenues, the difference is called **net loss.** The practice of pairing revenues with expenses on the income statement is called the **matching concept.**

The income statement in Exhibit 1.5 indicates that RCS has earned more assets than it has used. The statement shows that RCS has increased its assets by $35,000 (net income) as a result of operating its business. Observe the phrase *For the Year Ended December 31, 2012,* in the heading of the income statement. Income is measured for a span of time called the **accounting period.** While accounting periods of one year are normal for external financial reporting, income can be measured weekly, monthly, quarterly, semiannually, or over any other desired time period. Notice that the cash RCS paid to its stockholders (dividends) is not reported as expense. The decrease in assets for dividend payments is not incurred for the purpose of generating revenue. Instead, dividends are transfers of wealth to the owners of the business. Dividend payments are not reported on the income statement.

[6]The definitions for revenue and expense is expanded in subsequent chapters as additional relationships among the elements of financial statements are introduced.

EXHIBIT 1.5 Financial Statements

RUSTIC CAMP SITES
Income Statement
For the Year Ended December 31, 2012

Rental revenue (*asset increases*)		$ 85,000
Operating expenses (*asset decreases*)		(50,000)
Net income		$ 35,000

RUSTIC CAMP SITES
Statement of Changes in Stockholders' Equity
For the Year Ended December 31, 2012

Beginning common stock	$ 0	
Plus: common stock issued	120,000	
Ending common stock		$120,000
Beginning retained earnings	0	
Plus: Net income	35,000	
Less: Dividends	(4,000)	
Ending retained earnings		31,000
Total stockholders' equity		$151,000

RUSTIC CAMP SITES
Balance Sheet
As of December 31, 2012

Assets		
Cash	$ 51,000	
Land	500,000	
Total assets		$551,000
Liabilities		
Notes payable		$400,000
Stockholders' equity		
Common stock	$120,000	
Retained earnings	31,000	
Total stockholders' equity		151,000
Total liabilities and stockholders' equity		$551,000

RUSTIC CAMP SITES
Statement of Cash Flows
For the Year Ended December 31, 2012

Cash flows from operating activities:		
Cash receipts from revenue	$ 85,000	
Cash payments for expenses	(50,000)	
Net cash flow from operating activities		$ 35,000
Cash flows for investing activities:		
Cash payments to purchase land		(500,000)
Cash flows from financing activities:		
Cash receipts from borrowing funds	400,000	
Cash receipts from issuing common stock	120,000	
Cash payments for dividends	(4,000)	
Net cash flow from financing activities		516,000
Net increase in cash		51,000
Plus: beginning cash balance		0
Ending cash balance		$ 51,000

CHECK YOURSELF 1.3

Mahoney, Inc., was started when it issued common stock to its owners for $300,000. During its first year of operation Mahoney received $523,000 cash for services provided to customers. Mahoney paid employees $233,000 cash. Advertising costs paid in cash amounted to $102,000. Other cash operating expenses amounted to $124,000. Finally, Mahoney paid a $25,000 cash dividend to its stockholders. What amount of net income would Mahoney's report on its earnings statement?

Answer The amount of net income is $64,000 ($523,000 Revenue − $233,000 Salary Expense − $102,000 Advertising Expense − $124,000 Other Operating Expenses). The cash received from issuing stock is not revenue because it was not acquired from earnings activities. In other words, Mahoney did not work (perform services) for this money; it was contributed by owners of the business. The dividends are not expenses because the decrease in cash was not incurred for the purpose of generating revenue. Instead, the dividends represent a transfer of wealth to the owners.

Statement of Changes in Stockholders' Equity

The **statement of changes in stockholders' equity** explains the effects of transactions on stockholders' equity during the accounting period. It starts with the beginning balance in the common stock account. In the case of RCS, the beginning balance in the common stock account is zero because the company did not exist before the 2012 accounting period. The $120,000 of stock issued during the accounting period is added to the beginning balance to determine the ending balance in the common stock account.

In addition to reporting the changes in common stock, the statement describes the changes in retained earnings for the accounting period. RCS had no beginning balance in retained earnings. During the period, the company earned $35,000 and paid $4,000 in dividends to the stockholders, producing an ending retained earnings balance of $31,000 ($0 + $35,000 − $4,000). Since equity consists of common stock and retained earnings, the ending total equity balance is $151,000 ($120,000 + $31,000). This statement is also dated with the phrase *For the Year Ended December 31, 2012,* because it describes what happened to stockholders' equity during 2012.

Balance Sheet

The **balance sheet** draws its name from the accounting equation. Total assets balances with (equals) claims (liabilities and stockholders' equity) on those assets. The balance sheet for RCS is shown in Exhibit 1.5. Note that total claims (liabilities plus stockholders' equity) are equal to total assets ($551,000 = $551,000).

At this point we take a closer look at the term *assets*. Previously, we have defined assets as the resources a company uses to produce revenues. More precisely, the assets shown on a balance sheet represent the resources that a company plans to use *in the future* to generate revenues. In contrast, expenses represent the assets that have been used in the current period to generate revenues in the current period. In summary, businesses use resources to produce revenue. The resources that *have been sacrificed* to produce revenues in the current period are expenses. The resources that *will be sacrificed* in the future to produce future revenues are called assets.

Note the order of the assets in the balance sheet. Cash appears first, followed by land. Assets are displayed in the balance sheet based on their level of **liquidity.** This means that assets are listed in order of how rapidly they will be converted to cash. Finally, note that the balance sheet is dated with the phrase *As of December 31, 2012,* indicating that it describes the company's financial condition on the last day of the accounting period.

CHECK YOURSELF 1.4

To gain a clear understanding of the balance sheet, try to create one that describes your personal financial condition. First list your assets, then your liabilities. Determine the amount of your equity by subtracting your liabilities from your assets.

Answer Answers for this exercise will vary depending on the particular assets and liabilities each student identifies. Common student assets include automobiles, computers, stereos, TVs, phones, MP3 players, clothes, and textbooks. Common student liabilities include car loans, mortgages, student loans, and credit card debt. The difference between the assets and the liabilities is the equity.

Statement of Cash Flows

The **statement of cash flows** explains how a company obtained and used *cash* during the accounting period. Receipts of cash are called *cash inflows,* and payments are *cash outflows.* The statement classifies cash receipts (inflows) and payments (outflows) into three categories: financing activities, investing activities, and operating activities.

Businesses normally start with an idea. Implementing the idea usually requires cash. For example, suppose you decide to start an apartment rental business. First, you would need cash to buy the apartments. Acquiring cash to start a business is a financing activity. **Financing activities** include obtaining cash (inflow) from owners or paying cash (outflow) to owners (dividends). Financing activities also include borrowing cash (inflow) from creditors and repaying the principal (outflow) to creditors. Because interest on borrowed money is an expense, however, cash paid to creditors for interest is reported in the operating activities section of the statement of cash flows.

After obtaining cash from financing activities, you would invest the money by building or buying apartments. **Investing activities** involve paying cash (outflow) to purchase long-term assets or receiving cash (inflow) from selling long-term assets. Long-term assets are normally used for more than one year. Cash outflows to purchase land or cash inflows from selling a building are examples of investing activities.

After investing in the productive assets (apartments), you would engage in operating activities. **Operating activities** involve receiving cash (inflow) from revenue and paying cash (outflow) for expenses. Note that cash spent to purchase short-term assets such as office supplies is reported in the operating activities section because the office supplies would likely be used (expensed) within a single accounting period.

The primary cash inflows and outflows related to the types of business activity introduced in this chapter are summarized in Exhibit 1.6. The exhibit will be expanded as additional types of events are introduced in subsequent chapters.

The statement of cash flows for Rustic Camp Sites in Exhibit 1.5 shows that the amount of cash increased by $51,000 during the year. The beginning balance in the Cash account was zero; adding the $51,000 increase to the beginning balance results in a $51,000 ending balance. Notice that the $51,000 ending cash balance on the statement of cash flows is the same as the amount of cash reported in the asset section on the December 31 year-end balance sheet. Also, note that the statement of cash flows is dated with the phrase *For the Year Ended December 31, 2012,* because it describes what happened to cash over the span of the year.

EXHIBIT 1.6

Classification Scheme for Statement of Cash Flows

Cash flows from operating activities:
- Cash receipts (inflows) from customers
- Cash payments (outflows) to suppliers

Cash flows from investing activities:
- Cash receipts (inflows) from the sale of long-term assets
- Cash payments (outflows) for the purchase of long-term assets

Cash flows from financing activities:
- Cash receipts (inflows) from borrowing funds
- Cash receipts (inflows) from issuing common stock
- Cash payments (outflows) to repay borrowed funds
- Cash payments (outflows) for dividends

CHECK YOURSELF 1.5

Classify each of the following cash flows as an operating activity, investing activity, or financing activity.

1. Acquired cash from owners.
2. Borrowed cash from creditors.
3. Paid cash to purchase land.
4. Earned cash revenue.
5. Paid cash for salary expenses.
6. Paid cash dividend.
7. Paid cash for interest.

Answer (1) financing activity; (2) financing activity; (3) investing activity; (4) operating activity; (5) operating activity; (6) financing activity; (7) operating activity.

The Closing Process

As previously indicated transaction data are recorded in the Revenue, Expense, and Dividend accounts during the accounting period. At the end of the accounting period the data in theses accounts is transferred to the Retained Earnings account. The process of transferring the balances is called **closing.** Since the Revenue, Expense, and Dividend accounts are closed each period, they are called **temporary accounts.** At the beginning of each new accounting period, the temporary accounts have zero balances. The Retained Earnings account carries forward from one accounting period to the next. Since this account is not closed, it is called a **permanent account.**

Since RCS started operations on January 1, 2012, the beginning Retained Earnings account balance was zero. In other words, there were no previous earnings available to be retained by the business. During 2012, amounts were recorded in the Revenue, Expense, and Dividend accounts. Since the Retained Earnings account is separate from the Revenue, Expense, and Dividend accounts, the entries in these temporary accounts did not affect the Retained Earnings balance. Specifically, the *before closing* balance in the Retained Earnings account on December 31, 2012, is still zero. In contrast, the Revenue account has a balance of $85,000; the Expense account has a balance of $50,000; and the Dividends account has a balance of $4,000. The closing process transfers the balances in the Revenue, Expense, and Dividend accounts to the Retained Earnings account. Therefore, *after closing* the balance in the Retained Earnings account is $31,000 ($85,000 − $50,000 − $4,000) and the Revenue, Expense, and Dividend accounts have zero balances.

Since the asset, liability, common stock, and retained earnings accounts are permanent accounts, they are not closed at the end of the accounting period. After the closing account process, RCS's general ledger will contain the following account balances as of December 31, 2012.

Cash	+	Land	=	Notes Payable	+	Common Stock	+	Retained Earnings
51,000	+	500,000	=	400,000	+	120,000	+	31,000

Take note that the December 31, 2012, ending account balances become the January 1, 2013, beginning account balances. So, RCS will start the 2013 accounting period with these same accounts balances. In other words, the current period's after closing ending balances become the next period's beginning balances.

CHECK YOURSELF 1.6

After closing on December 31, 2012, Walston Company had $4,600 of assets, $2,000 of liabilities, and $700 of common stock. During January of 2013, Walston earned $750 of revenue and incurred $300 of expense. Walston closes it books each year on December 31.

1. Determine the balance in the Retained Earnings account as of December 31, 2012.
2. Determine the balance in the Retained Earnings account as of January 1, 2013.
3. Determine the balance in the Retained Earnings account as of January 31, 2013.

Answer

1. Assets = Liabilities + Common Stock + Retained Earnings
   $4,600 = $2,000 + $700 + Retained Earnings
   Retained Earnings = $1,900
2. The balance in the Retained Earnings account on January 1, 2013, is the same as it was on December 31, 2012. This year's ending balance becomes next year's beginning balance. Therefore, the balance in the Retained Earnings account on January 1, 2013, is $1,900.
3. The balance in the Retained Earnings account on January 31, 2013, is still $1,900. The revenue earned and expenses incurred during January are not recorded in the Retained Earnings account. Revenue is recorded in a Revenue account and expenses are recorded in an Expense account during the accounting period. The balances in the Revenue and Expense accounts are transferred to the Retained Earnings account during the closing process at the end of the accounting period (December 31, 2013).

THE HORIZONTAL FINANCIAL STATEMENTS MODEL

LO 6

Record business events using a horizontal financial statements model.

Financial statements are the scorecard for business activity. If you want to succeed in business, you must know how your business decisions affect your company's financial statements. This text uses a **horizontal statements model** to help you understand how business events affect financial statements. This model shows a set of financial statements horizontally across a single page of paper. The balance sheet is displayed first, adjacent to the income statement, and then the statement of cash flows. Because the effects of equity transactions can be analyzed by referring to certain balance sheet columns, and because of limited space, the statement of changes in stockholders' equity is not shown in the horizontal statements model.

The model frequently uses abbreviations. For example, activity classifications in the statement of cash flows are identified using OA for operating activities, IA for investing activities, and FA for financing activities. NC designates the net change in cash. The statements model uses "NA" when an account is not affected by an event. The background of the *balance sheet* is red, the *income statement* is blue, and the *statement of cash flows* is green. To demonstrate the usefulness of the horizontal statements model, we use it to display the seven accounting events that RCS experienced during its first year of operation (2012).

1. RCS acquired $120,000 cash from the issuance of common stock.
2. RCS borrowed $400,000 cash.
3. RCS paid $500,000 cash to purchase land.
4. RCS received $85,000 cash from earning revenue.
5. RCS paid $50,000 cash for expenses.
6. RCS paid $4,000 of cash dividends to the owners.
7. The market value of the land owned by RCS was appraised at $525,000 on December 31, 2012.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows	
	Assets			=	Liab.	+	Stockholders' Equity									
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.		
Beg. bal.	0	+	0	=	0	+	0	+	0	0	−	0	=	0	NA	
1.	120,000	+	NA	=	NA	+	120,000	+	NA	NA	−	NA	=	NA	120,000	FA
2.	400,000	+	NA	=	400,000	+	NA	+	NA	NA	−	NA	=	NA	400,000	FA
3.	(500,000)	+	500,000	=	NA	+	NA	+	NA	NA	−	NA	=	NA	(500,000)	IA
4.	85,000	+	NA	=	NA	+	NA	+	85,000	85,000	−	NA	=	85,000	85,000	OA
5.	(50,000)	+	NA	=	NA	+	NA	+	(50,000)	NA	−	50,000	=	(50,000)	(50,000)	OA
6.	(4,000)	+	NA	=	NA	+	NA	+	(4,000)	NA	−	NA	=	NA	(4,000)	FA
7.	NA	+	NA	=	NA	+	NA	+	NA	NA	−	NA	=	NA	NA	
Totals	51,000	+	500,000	=	400,000	+	120,000	+	31,000	85,000	−	50,000	=	35,000	51,000	NC

Recognize that statements models are learning tools. Because they are helpful in understanding how accounting events affect financial statements, they are used extensively in this book. However, the models omit many of the details used in published financial statements. For example, the horizontal model shows only a partial set of statements. Also, since the statements are presented in aggregate, the description of dates (i.e., "as of" versus "for the period ended") does not distinguish periodic from cumulative data.

REAL-WORLD FINANCIAL REPORTS

As previously indicated, organizations exist in many different forms, including *business* entities and *not-for-profit* entities. Business entities are typically service, merchandising, or manufacturing companies. **Service businesses,** which include doctors, attorneys, accountants, dry cleaners, and maids, provide services to their customers. **Merchandising businesses,** sometimes called *retail* or *wholesale companies,* sell goods to customers that other entities make. **Manufacturing businesses** make the goods that they sell to their customers.

Some business operations include combinations of these three categories. For example, an automotive repair shop might change oil (service function), sell parts such as oil filters (retail function), and rebuild engines (manufacturing function). The nature of the reporting entity affects the form and content of the information reported in an entity's financial statements. For example, governmental entities provide statements of revenues, expenditures, and changes in fund equity while business entities provide income statements. Similarly, income statements of retail companies show an expense

Service

Merchandising

Manufacturing

REALITY BYTES

On April 19, 2010, the stock of **BP, Plc.** (formally known as **British Petroleum**) was trading at $59.48 per share. On that same day, the stock of **Chevron Corp.** was trading at $81.32 and the stock of **Exxon Mobil Corp.** was trading at $68.23. About six weeks later, on June 4, 2010, these companies' stocks had fallen to $37.16, $71.28, and $59.53 per share, respectively. Why did this happen? Did the companies report a large drop in their net earnings during these six weeks? No. What happened was that on April 20, 2010, the Deepwater Horizon oil well, owned by BP, failed and began discharging 60,000 barrels of oil daily into the Gulf of Mexico.

While it is easy to see why this event could cause BP's stock to lose 38 percent of its value, why would this cause Chevron's stock to fall 12 percent and Exxon's stock to fall 13 percent? These two companies did not have any oil spills during this time. One reason that the stock price of most oil companies declined significantly after BP's problems was that investors were concerned the failure would result in tighter regulation of all oil companies. Additionally, there was the concern that the government would ban, or seriously reduce, all future deepwater drilling. More regulations, and certainly a ban on future drilling, could drastically reduce the future earnings potential of all oil companies, not just BP.

As this situation illustrates, investors frequently use information not yet reported in a company's annual report. The annual report focuses on historical data, but investors are more concerned about the future. The historical information contained in the annual report is important because the past is frequently a strong predictor of the future. However, current negative news, such as an oil spill, may give investors more information about a company's furture than last year's annual report. For example, while the oil spill was bad news for the oil companies, it was, in financial terms, good news for companies that manufacture the oil-booms used to prevent oil from reaching the beaches. Similarly, a new company, that has never earned a profit, may have an idea that is so innovative investors rush to buy it stock, even though they expect it to be a few years to have positive earnings. Also, investors and creditors may be motivated by nonfinancial considerations such as social consciousness, humanitarian concerns, or personal preferences. While accounting information is critically important, it is only one dimension of the information pool that investors and creditors use to make decisions.

item called *cost of goods sold,* but service companies that do not sell goods have no such item in their income statements. You should expect some diversity when reviewing real-world financial statements.

Annual Report for Target Corporation

Organizations normally provide information, including financial statements, to *stakeholders* yearly in a document known as an **annual report.** The annual report for **Target Corporation** is reproduced in Appendix B of this text. This report includes the company's financial statements. Immediately following the statements are footnotes that provide additional details about the items described in the statements. The annual report contains commentary describing management's assessment of significant events that affected the company during the reporting period. This commentary is called *management's discussion and analysis* (MD&A).

The U.S. Securities and Exchange Commission (SEC) requires public companies to file an annual report in a document known as a 10-K. Even though the annual report is usually flashier (contains more color and pictures) than the 10-K, the 10-K is normally more comprehensive with respect to content. As a result, the 10-K report frequently substitutes for the annual report, but the annual report cannot substitute for the 10-K. In an effort to reduce costs, many companies now use the 10-K report as their annual report.

Special Terms in Real-World Reports

The financial statements of real-world companies include numerous items relating to advanced topics that are not covered in survey accounting textbooks, especially the first chapter of a survey accounting textbook. Do not, however, be discouraged from browsing through real-world annual reports. You will significantly enhance your learning if you look at many annual reports and attempt to identify as many items as you can. As your accounting knowledge grows, you will likely experience increased interest in real-world financial reports and the businesses they describe.

We encourage you to look for annual reports in the library or ask your employer for a copy of your company's report. The Internet is another excellent source for obtaining annual reports. Most companies provide links to their annual reports on their home pages. Look for links labeled "about the company" or "investor relations" or other phrases that logically lead to the company's financial reports. The best way to learn accounting is to use it. Accounting is the language of business. Learning the language will serve you well in almost any area of business that you pursue.

<< A Look Back

This chapter introduced the role of accounting in society and business: to provide information helpful in operating and evaluating the performance of organizations. Accounting is a measurement discipline. To communicate effectively, users of accounting must agree on the rules of measurement. *Generally accepted accounting principles (GAAP)* constitute the rules used by the accounting profession in the United States to govern financial reporting. GAAP is a work in progress that continues to evolve.

This chapter has discussed eight elements of financial statements: *assets, liabilities, equity, common stock (contributed capital), revenue, expenses, dividends (distributions),* and *net income.* The elements represent broad classifications reported on financial statements. Four basic financial statements appear in the reports of public companies: the *balance sheet,* the *income statement,* the *statement of changes in stockholders' equity,* and the *statement of cash flows.* The chapter discussed the form and content of each statement as well as the interrelationships among the statements.

This chapter introduced a *horizontal financial statements model* as a tool to help you understand how business events affect a set of financial statements. This model is used throughout the text. You should carefully study this model before proceeding to Chapter 2.

>> A Look Forward

To keep matters as simple as possible and to focus on the interrelationships among financial statements, this chapter considered only cash events. Obviously, many real-world events do not involve an immediate exchange of cash. For example, customers use telephone service throughout the month without paying for it until the next month. Such phone usage represents an expense in one month with a cash exchange in the following month. Events such as this are called *accruals.* Understanding the effects that accrual events have on the financial statements is included in Chapter 2.

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A step-by-step audio-narrated series of slides is provided on the text website at www.mhhe.com/edmondssurvey3e.

SELF-STUDY REVIEW PROBLEM

During 2013 Rustic Camp Sites experienced the following transactions.

1. RCS acquired $32,000 cash by issuing common stock.
2. RCS received $116,000 cash for providing services to customers (leasing camp sites).
3. RCS paid $13,000 cash for salaries expense.
4. RCS paid a $9,000 cash dividend to the owners.

5. RCS sold land that had cost $100,000 for $100,000 cash.
6. RCS paid $47,000 cash for other operating expenses.

Required

a. Record the transaction data in a horizontal financial statements model like the following one. In the Cash Flow column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The beginning balances have been recorded as an example. They are the ending balances shown on RCS's December 31, 2012, financial statements illustrated in the chapter. Note that the revenue and expense accounts have a zero beginning balance. Amounts in these accounts apply only to a single accounting period. Revenue and expense account balances are not carried forward from one accounting period to the next.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity								
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
Beg. bal.	51,000	+	500,000	=	400,000	+	120,000	+	31,000	NA	−	NA	=	NA	NA

b. Explain why there are no beginning balances in the Income Statement columns.
c. What amount of net income will RCS report on the 2013 income statement?
d. What amount of total assets will RCS report on the December 31, 2013, balance sheet?
e. What amount of retained earnings will RCS report on the December 31, 2013, balance sheet?
f. What amount of net cash flow from operating activities will RCS report on the 2013 statement of cash flows?

Solution

a.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Assets			=	Liab.	+	Stockholders' Equity								
	Cash	+	Land	=	N. Pay.	+	Com. Stk.	+	Ret. Earn.	Rev.	−	Exp.	=	Net Inc.	
Beg. bal.	51,000	+	500,000	=	400,000	+	120,000	+	31,000	NA	−	NA	=	NA	NA
1.	32,000	+	NA	=	NA	+	32,000	+	NA	NA	−	NA	=	NA	32,000 FA
2.	116,000	+	NA	=	NA	+	NA	+	116,000	116,000	−	NA	=	116,000	116,000 OA
3.	(13,000)	+	NA	=	NA	+	NA	+	(13,000)	NA	−	13,000	=	(13,000)	(13,000) OA
4.	(9,000)	+	NA	=	NA	+	NA	+	(9,000)	NA	−	NA	=	NA	(9,000) FA
5.	100,000	+	(100,000)	=	NA	+	NA	+	NA	NA	−	NA	=	NA	100,000 IA
6.	(47,000)	+	NA	=	NA	+	NA	+	(47,000)	NA	−	47,000	=	(47,000)	(47,000) OA
Totals	230,000	+	400,000	=	400,000	+	152,000	+	78,000	116,000	−	60,000	=	56,000	179,000 NC*

*The letters NC on the last line of the column designate the net change in cash.

b. The revenue and expense accounts are temporary accounts used to capture data for a single accounting period. They are closed (amounts removed from the accounts) to retained earnings at the end of the accounting period and therefore always have zero balances at the beginning of the accounting cycle.

c. RCS will report net income of $56,000 on the 2013 income statement. Compute this amount by subtracting the expenses from the revenue ($116,000 Revenue − $13,000 Salaries expense − $47,000 Other operating expense).

d. RCS will report total assets of $630,000 on the December 31, 2013, balance sheet. Compute total assets by adding the cash amount to the land amount ($230,000 Cash + $400,000 Land).

e. RCS will report retained earnings of $78,000 on the December 31, 2013, balance sheet. Compute this amount using the following formula: Beginning retained earnings + Net income − Dividends = Ending retained earnings. In this case, $31,000 + $56,000 − $9,000 = $78,000.

f. Net cash flow from operating activities is the difference between the amount of cash collected from revenue and the amount of cash spent for expenses. In this case, $116,000 cash inflow from revenue − $13,000 cash outflow for salaries expense − $47,000 cash outflow for other operating expenses = $56,000 net cash inflow from operating activities.

KEY TERMS

accounting 2
accounting equation 12
accounting event 13
accounting period 15
accounts 11
annual report 25
articulation 18
asset exchange transaction 14
asset source transaction 13
asset use transaction 15
assets 4
balance sheet 9
claims 4
closing 22
common stock 12
creditors 4
dividend 16
double-entry bookkeeping 14
earnings 4
elements 10
equity 12
expenses 15
financial accounting 6
Financial Accounting Standards Board (FASB) 8
financial resources 4
financial statements 10
financing activities 21
general ledger 17
generally accepted accounting principles (GAAP) 8
historical cost concept 16
horizontal statements model 23
income 4
income statement 18
International Accounting Standards Board (IASB) 9
International Financial Reporting Standards (IFRS) 9
interest 5
investing activities 21
investors 4
labor resources 4
liabilities 10
liquidation 4
liquidity 20
managerial accounting 6
manufacturing businesses 24
market 4
matching concept 18
merchandising businesses 24
net income 18
net loss 18
not-for-profit entities 6
operating activities 21
permanent accounts 22
physical resources 5
profit 4
reliability concept 16
reporting entities 9
retained earnings 12
revenue 10
service businesses 24
stakeholders 6
statement of cash flows 10
statement of changes in stockholders' equity 10
stockholders 12
stockholders' equity 12
temporary accounts 22
transaction 12
users 6

QUESTIONS

1. Explain the term *stakeholder.* Distinguish between stakeholders with a direct versus an indirect interest in the companies that issue accounting reports.

2. Why is accounting called the *language of business?*

3. What is the primary mechanism used to allocate resources in the United States?

4. In a business context, what does the term *market* mean?

5. What market trilogy components are involved in the process of transforming resources into finished products?

6. Give an example of a financial resource, a physical resource, and a labor resource.

7. What type of return does an investor expect to receive in exchange for providing financial resources to a business? What type of return does a creditor expect from providing financial resources to an organization or business?

8. How do financial and managerial accounting differ?

9. Describe a not-for-profit or nonprofit enterprise. What is the motivation for this type of entity?

10. What are the U.S. rules of accounting information measurement called?

11. Explain how a career in public accounting differs from a career in private accounting.

12. Distinguish between elements of financial statements and accounts.

13. What role do assets play in business profitability?

14. To whom do the assets of a business belong?

15. What is the nature of creditors' claims on assets?

16. What term describes creditors' claims on the assets of a business?
17. What is the accounting equation? Describe each of its three components.
18. Who ultimately bears the risk and collects the rewards associated with operating a business?
19. What does a *double-entry bookkeeping system* mean?
20. How does acquiring capital from owners affect the accounting equation?
21. What is the difference between assets that are acquired by issuing common stock and those that are acquired using retained earnings?
22. How does earning revenue affect the accounting equation?
23. What are the three primary sources of assets?
24. What is the source of retained earnings?
25. How does distributing assets (paying dividends) to owners affect the accounting equation?
26. What are the similarities and differences between dividends and expenses?
27. What four general-purpose financial statements do business enterprises use?
28. Which of the general-purpose financial statements provides information about the enterprise at a specific designated date?
29. What causes a net loss?
30. What three categories of cash receipts and cash payments do businesses report on the statement of cash flows? Explain the types of cash flows reported in each category.
31. How are asset accounts usually arranged in the balance sheet?
32. Discuss the term *articulation* as it relates to financial statements.
33. How do temporary accounts differ from permanent accounts? Name three temporary accounts. Is retained earnings a temporary or a permanent account?
34. What is the historical cost concept and how does it relate to the reliability concept?
35. Identify the three types of accounting transactions discussed in this chapter. Provide an example of each type of transaction, and explain how it affects the accounting equation.
36. What type of information does a business typically include in its annual report?
37. What is U.S. GAAP? What is IFRS?

MULTIPLE-CHOICE QUESTIONS

Multiple-choice questions are provided on the text website at www.mhhe.com/edmondssurvey3e.

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EXERCISES

All applicable Exercises are available with McGraw-Hill's *Connect Accounting.*

connect ACCOUNTING

Exercise 1-1 *The role of accounting in society*

LO 1

Free economies use open markets to allocate resources.

Required

Identify the three participants in a free business market. Write a brief memo explaining how these participants interact to ensure that goods and services are distributed in a manner that satisfies consumers. Your memo should include answers to the following questions: If you work as a public accountant, what role would you play in the allocation of resources? Which professional certification would be most appropriate to your career?

Exercise 1-2 *Distributions in a business liquidation*

LO 1

Assume that Kennedy Company acquires $1,600 cash from creditors and $1,800 cash from investors.

Required

a. Explain the primary differences between investors and creditors.

b. If Kennedy has a net loss of $1,600 cash and then liquidates, what amount of cash will the creditors receive? What amount of cash will the investors receive?

c. If Kennedy has net income of $1,600 and then liquidates, what amount of cash will the creditors receive? What amount of cash will the investors receive?

LO 1

Exercise 1-3 *Careers in accounting*

Accounting is commonly divided into two sectors. One sector is called public accounting. The other sector is called private accounting.

Required

a. Identify three areas of service provided by public accountants.
b. Describe the common duties performed by private accountants.

LO 1

Exercise 1-4 *Identifying the reporting entities*

Kenneth Chang recently started a business. During the first few days of operation, Mr. Chang transferred $30,000 from his personal account into a business account for a company he named Chang Enterprises. Chang Enterprises borrowed $40,000 from First Bank. Mr. Chang's father-in-law, Jim Harwood, invested $64,000 into the business for which he received a 25 percent ownership interest. Chang Enterprises purchased a building from Morton Realty Company. The building cost $120,000 cash. Chang Enterprises earned $28,000 in revenue from the company's customers and paid its employees $25,000 for salaries expense.

Required

Identify the entities that were mentioned in the scenario and explain what happened to the cash accounts of each entity that you identify.

LO 2

Exercise 1-5 *Titles and accounts appearing on financial statements*

Annual reports normally include an income statement, a statement of changes in stockholders' equity, a balance sheet, and a statement of cash flows.

Required

Identify the financial statements on which each of the following titles or accounts would appear. If a title or an account appears on more than one statement, list all statements that would include it.

a. Common Stock
b. Land
c. Ending Cash Balance
d. Beginning Cash Balance
e. Notes Payable
f. Retained Earnings
g. Revenue
h. Cash Dividends
i. Financing Activities
j. Salaries Expense

LO 2

Exercise 1-6 *Components of the accounting equation*

Required

The following three requirements are independent of each other.

a. Craig's Cars has assets of $4,550 and stockholders' equity of $3,200. What is the amount of liabilities? What is the amount of claims?
b. Heavenly Bakery has liabilities of $4,800 and stockholders' equity of $5,400. What is the amount of assets?
c. Bell's Candy Co. has assets of $49,200 and liabilities of $28,200. What is the amount of stockholders' equity?

LO 2

Exercise 1-7 *Missing information in the accounting equation*

Required

Calculate the missing amounts in the following table.

						Stockholders' Equity		
Company	Assets	=	Liabilities	+	Common Stock	+	Retained Earnings
A	$?		$25,000		$48,000		$50,000
B	40,000		?		7,000		30,000
C	75,000		15,000		?		42,000
D	125,000		45,000		60,000		?

Exercise 1-8 *Missing information in the accounting equation* LO 2

As of December 31, 2012, Eber Company had total assets of $156,000, total liabilities of $85,600, and common stock of $52,400. During 2013 Eber earned $36,000 of cash revenue, paid $20,000 for cash expenses, and paid a $2,000 cash dividend to the stockholders.

Required

a. Determine the amount of retained earnings as of December 31, 2012, after closing.

b. Determine the amount of net income earned in 2013.

c. Determine the amount of retained earnings as of December 31, 2013, after closing.

d. Determine the amount of cash that is in the retained earnings account as of December 31, 2013.

Exercise 1-9 *Missing information for determining net income* LO 2

The December 31, 2012, balance sheet for Classic Company showed total stockholders' equity of $82,500. Total stockholders' equity increased by $53,400 between December 31, 2012, and December 31, 2013. During 2013 Classic Company acquired $13,000 cash from the issue of common stock. Classic Company paid an $8,000 cash dividend to the stockholders during 2013.

Required

Determine the amount of net income or loss Classic reported on its 2013 income statement. (*Hint:* Remember that stock issues, net income, and dividends all change total stockholders' equity.)

Exercise 1-10 *Effect of events on the accounting equation* LO 2, 3

Olive Enterprises experienced the following events during 2012.

1. Acquired cash from the issue of common stock.
2. Paid cash to reduce the principal on a bank note.
3. Sold land for cash at an amount equal to its cost.
4. Provided services to clients for cash.
5. Paid utilities expenses with cash.
6. Paid a cash dividend to the stockholders.

Required

Explain how each of the events would affect the accounting equation by writing the letter I for increase, the letter D for decrease, and NA for does not affect under each of the components of the accounting equation. The first event is shown as an example.

						Stockholders' Equity		
Event Number	Assets	=	Liabilities	+	Common Stock	+	Retained Earnings
1	I		NA		I		NA

LO 2, 3

Exercise 1-11 *Effects of issuing stock*

Shiloh Company was started in 2012 when it acquired $15,000 cash by issuing common stock. The cash acquisition was the only event that affected the business in 2012.

Required

Write an accounting equation, and record the effects of the stock issue under the appropriate general ledger account headings.

LO 2, 3

Exercise 1-12 *Effects of borrowing*

Marcum Company was started in 2012 when it issued a note to borrow $6,200 cash.

Required

Write an accounting equation, and record the effects of the borrowing transaction under the appropriate general ledger account headings.

LO 2, 3

Exercise 1-13 *Effects of revenue, expense, dividend, and the closing process*

Rhodes Company was started on January 1, 2011. During 2012, the company experienced the following three accounting events: (1) earned cash revenues of $13,500, (2) paid cash expenses of $9,200, and (3) paid a $500 cash dividend to its stockholders. These were the only events that affected the company during 2012.

Required

a. Write an accounting equation, and record the effects of each accounting event under the appropriate general ledger account headings.
b. Prepare an income statement for the 2012 accounting period and a balance sheet at the end of 2012 for Rhodes Company.
c. What is the balance in the Retained Earnings account immediately after the cash revenue is recognized?
d. What is the balance in the Retained Earnings account after the closing process is complete?

LO 2, 3

Exercise 1-14 *Effect of transactions on general ledger accounts*

At the beginning of 2012, J & J Corp.'s accounting records had the following general ledger accounts and balances.

J & J CORP.
Accounting Equation

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for RE
	Cash	Land		Notes Payable		Common Stock	Retained Earnings	
Balance 1/1/2012	10,000	20,000		12,000		7,000	11,000	

J & J Corp. completed the following transactions during 2012.

1. Purchased land for $5,000 cash.
2. Acquired $25,000 cash from the issue of common stock.
3. Received $75,000 cash for providing services to customers.
4. Paid cash operating expenses of $42,000.
5. Borrowed $10,000 cash from the bank.
6. Paid a $5,000 cash dividend to the stockholders.
7. Determined that the market value of the land is $35,000.

Required

a. Record the transactions in the appropriate general ledger accounts. Record the amounts of revenue, expense, and dividends in the Retained Earnings column. Provide the appropriate titles for these accounts in the last column of the table.

b. Determine the net cash flow from financing activities.

c. What is the balance in the Retained Earnings account as of January 1, 2013?

Exercise 1-15 *Classifying events as asset source, use, or exchange* LO 4

BJ's Business Services experienced the following events during its first year of operations.

1. Acquired $10,000 cash from the issue of common stock.
2. Borrowed $8,000 cash from First Bank.
3. Paid $4,000 cash to purchase land.
4. Received $5,000 cash for providing boarding services.
5. Acquired an additional $2,000 cash from the issue of common stock.
6. Purchased additional land for $3,500 cash.
7. Paid $2,500 cash for salary expense.
8. Signed a contract to provide additional services in the future.
9. Paid $1,000 cash for rent expense.
10. Paid a $1,000 cash dividend to the stockholders.
11. Determined the market value of the land to be $8,000 at the end of the accounting period.

Required

Classify each event as an asset source, use, or exchange transaction or as not applicable (NA).

Exercise 1-16 *Classifying items for the statement of cash flows* LO 5

Required

Indicate how each of the following would be classified on the statement of cash flows as operating activities (OA), investing activities (IA), financing activities (FA), or not applicable (NA).

a. Paid $4,000 cash for salary expense.

b. Borrowed $8,000 cash from State Bank.

c. Received $30,000 cash from the issue of common stock.

d. Purchased land for $8,000 cash.

e. Performed services for $14,000 cash.

f. Paid $4,200 cash for utilities expense.

g. Sold land for $7,000 cash.

h. Paid a cash dividend of $1,000 to the stockholders.

i. Hired an accountant to keep the books.

j. Paid $3,000 cash on the loan from State Bank.

Exercise 1-17 *Preparing financial statements* LO 2, 3, 5

Montana Company experienced the following events during 2012.

1. Acquired $30,000 cash from the issue of common stock.
2. Paid $12,000 cash to purchase land.
3. Borrowed $10,000 cash.
4. Provided services for $20,000 cash.
5. Paid $1,000 cash for rent expense.
6. Paid $15,000 cash for other operating expenses.
7. Paid a $2,000 cash dividend to the stockholders.
8. Determined that the market value of the land purchased in Event 2 is now $12,700.

Required

a. The January 1, 2012, general ledger account balances are shown in the following accounting equation. Record the eight events in the appropriate general ledger accounts. Record the amounts of revenue, expense, and dividends in the Retained Earnings column. Provide the appropriate titles for these accounts in the last column of the table. The first event is shown as an example.

MONTANA COMPANY
Accounting Equation

Event	Assets		=	Liabilities	+	Stockholders' Equity		Acct. Titles for RE
	Cash	Land		Notes Payable		Common Stock	Retained Earnings	
Balance 1/1/2012	2,000	12,000		0		6,000	8,000	
1.	30,000					30,000		

b. Prepare an income statement, statement of changes in equity, year-end balance sheet, and statement of cash flows for the 2012 accounting period.

c. Determine the percentage of assets that were provided by retained earnings. How much cash is in the retained earnings account?

LO 5

Exercise 1-18 *Retained earnings and the closing process*

Davis Company was started on January 1, 2012. During the month of January, Davis earned $4,600 of revenue and incurred $3,000 of expense. Davis closes its books on December 31 of each year.

Required

a. Determine the balance in the Retained Earnings account as of January 31, 2012.

b. Comment on whether retained earnings is an element of financial statements or an account.

c. What happens to the Retained Earnings account at the time expenses are recognized?

LO 5

Exercise 1-19 *Relationship between assets and retained earnings*

Washington Company was organized when it acquired $2,000 cash from the issue of common stock. During its first accounting period the company earned $800 of cash revenue and incurred $500 of cash expenses. Also, during the accounting period the company paid its owners a $200 cash dividend.

Required

a. Determine the balance in the Retained Earnings account before and after the temporary accounts are closed.

b. As of the end of the accounting period, determine what percentage of total assets were provided by retained earnings.

LO 5

Exercise 1-20 *Historical cost versus market value*

Hilltop, Inc., purchased land in January 2009 at a cost of $270,000. The estimated market value of the land is $350,000 as of December 31, 2012.

Required

a. Name the December 31, 2012, financial statement(s) on which the land will be shown.

b. At what dollar amount will the land be shown in the financial statement(s)?

c. Name the key concept that will be used in determining the dollar amount that will be reported for land that is shown in the financial statement(s).

Exercise 1-21 *Relating accounting events to entities*

LO 1, 4, 5

Wright Company was started in 2012 when it acquired $25,000 cash by issuing common stock to Cal Wright.

Required

a. Was this event an asset source, use, or exchange transaction for Wright Company?

b. Was this event an asset source, use, or exchange transaction for Cal Wright?

c. Was the cash flow an operating, investing, or a financing activity on Wright Company's 2012 statement of cash flows?

d. Was the cash flow an operating, investing, or a financing activity on Cal Wright's 2012 statement of cash flows?

Exercise 1-22 *Effect of events on a horizontal financial statements model*

LO 6

City Consulting Services experienced the following events during 2012.

1. Acquired cash by issuing common stock.
2. Collected cash for providing tutoring services to clients.
3. Borrowed cash from a local government small business foundation.
4. Purchased land for cash.
5. Paid cash for operating expenses.
6. Paid a cash dividend to the stockholders.
7. Determined that the market value of the land is higher than its historical cost.

Required

Use a horizontal statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (I), decreases (D), or does not affect (NA) each element of the financial statements. Also, in the Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction is shown as an example.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Cash	+	Land	=	N. Pay	+	C. Stock.	+	Ret. Ear.	Rev.	−	Exp.	=	Net Inc.	
1.	I	+	NA	=	NA	+	I	+	NA	NA	−	NA	=	NA	I FA

Exercise 1-23 *Record events in the horizontal statements model*

LO 6

Expo Co. was started in 2012. During 2012, the company (1) acquired $11,000 cash from the issue of common stock, (2) earned cash revenue of $18,000, (3) paid cash expenses of $10,500, and (4) paid a $1,000 cash dividend to the stockholders.

Required

a. Record these four events in a horizontal statements model. Also, in the Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first event is shown as an example.

Event No.	Balance Sheet							Income Statement					Statement of Cash Flows
	Cash	=	N. Pay	+	C. Stock.	+	Ret. Ear.	Rev.	−	Exp.	=	Net Inc.	
1.	11,000	=	NA	+	11,000	+	NA	NA	−	NA	=	NA	11,000 FA

b. What does the income statement tell you about the assets of this business?

LO 6

Exercise 1-24 *Effect of events on a horizontal statements model*

Solito, Inc., was started on January 1, 2012. The company experienced the following events during its first year of operation.

1. Acquired $50,000 cash from the issue of common stock.
2. Paid $12,000 cash to purchase land.
3. Received $50,000 cash for providing tax services to customers.
4. Paid $9,500 cash for salary expense.
5. Acquired $5,000 cash from the issue of additional common stock.
6. Borrowed $10,000 cash from the bank.
7. Purchased additional land for $10,000 cash.
8. Paid $8,000 cash for other operating expenses.
9. Paid a $2,800 cash dividend to the stockholders.
10. Determined that the market value of the land is $25,000.

Required

a. Record these events in a horizontal statements model. Also, in the Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first event is shown as an example.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Cash	+	Land	=	N. Pay	+	C. Stock.	+	Ret. Ear.	Rev.	−	Exp.	=	Net Inc.	
1.	50,000	+	NA	=	NA	+	50,000	+	NA	NA	−	NA	=	NA	50,000 FA

b. What is the net income earned in 2012?
c. What is the amount of total assets at the end of 2012?
d. What is the net cash flow from operating activities for 2012?
e. What is the net cash flow from investing activities for 2012?
f. What is the net cash flow from financing activities for 2012?
g. What is the cash balance at the end of 2012?
h. As of the end of the year 2012, what percentage of total assets were provided by creditors, investors, and retained earnings?
i. What is the balance in the Retained Earnings account immediately after Event 4 is recorded?

LO 4, 6

Exercise 1-25 *Types of transactions and the horizontal statements model*

Partner's Pet Store experienced the following events during its first year of operations, 2012.

1. Acquired cash by issuing common stock.
2. Purchased land with cash.
3. Borrowed cash from a bank.
4. Signed a contract to provide services in the future.
5. Paid a cash dividend to the stockholders.
6. Paid cash for operating expenses.
7. Determined that the market value of the land is higher than the historical cost.

Required

a. Indicate whether each event is an asset source, use, or exchange transaction.
b. Use a horizontal statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (I), decreases (D), or does not affect (NA) each element of the financial statements. Also, in the Cash

Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction is shown as an example.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Cash	+	Land	=	N. Pay	+	C. Stock.	+	Ret. Ear.	Rev.	−	Exp.	=	Net Inc.	
1.	I	+	NA	=	NA	+	I	+	NA	NA	−	NA	=	NA	I FA

Exercise 1-26 *International Financial Reporting Standards*

IFRS

Seacrest Company is a U.S.–based company that develops its financial statements under GAAP. The total amount of the company's assets shown on its December 31, 2012, balance sheet was approximately $225 million. The president of Seacrest is considering the possibility of relocating the company to a country that practices accounting under IFRS. The president has hired an international accounting firm to determine what the company's statements would look like if they were prepared under IFRS. One striking difference is that under IFRS the assets shown on the balance sheet would be valued at approximately $275 million.

Required

a. Would Seacrest's assets really be worth $50 million more if it moves its headquarters?

b. Discuss the underlying conceptual differences between U.S. GAAP and IFRS that cause the difference in the reported asset values.

PROBLEMS

All applicable Problems are available with McGraw-Hill's *Connect Accounting.*

Problem 1-27 *Accounting's role in not-for-profits*

LO 1

Teresa Hill is struggling to pass her introductory accounting course. Teresa is intelligent but she likes to party. Studying is a low priority for Teresa. When one of her friends tells her that she is going to have trouble in business if she doesn't learn accounting, Teresa responds that she doesn't plan to go into business. She says that she is arts oriented and plans someday to be a director of a museum. She is in the school of business to develop her social skills, not her quantitative skills. Teresa says she won't have to worry about accounting, since museums are not intended to make a profit.

Required

a. Write a brief memo explaining whether you agree or disagree with Teresa's position regarding accounting and not-for-profit organizations.

b. Distinguish between financial accounting and managerial accounting.

c. Identify some of the stakeholders of not-for-profit institutions that would expect to receive financial accounting reports.

d. Identify some of the stakeholders of not-for-profit institutions that would expect to receive managerial accounting reports.

Problem 1-28 *Accounting entities*

LO 1

The following business scenarios are independent from one another.

1. Beth Mays purchased an automobile from Mills Bros. Auto Sales for $9,000.
2. Bill Becham loaned $15,000 to the business in which he is a stockholder.
3. First State Bank paid interest to Levi Co. on a certificate of deposit that Levi Co. has invested at First State Bank.
4. Southside Restaurant paid the current utility bill of $128 to Midwest Utilities.
5. Filmore, Inc., borrowed $50,000 from City National Bank and used the funds to purchase land from Tuchols Realty.

CHECK FIGURE

1. Entities mentioned: Beth Mays and Mills Bros. Auto Sales

6. Jing Chu purchased $10,000 of common stock of International Sales Corporation from the corporation.
7. Bill Mann loaned $4,000 cash to his daughter.
8. Research Service Co. earned $5,000 in cash revenue.
9. Yang Imports paid $1,500 for salaries to each of its four employees.
10. Meyers Inc. paid a cash dividend of $3,000 to its sole shareholder, Mark Meyers.

Required

a. For each scenario, create a list of all of the entities that are mentioned in the description.
b. Describe what happens to the cash account of each entity that you identified in Requirement *a.*

LO 2, 5

Problem 1-29 *Relating titles and accounts to financial statements*

Required

Identify the financial statements on which each of the following items (titles, date descriptions, and accounts) appears by placing a check mark in the appropriate column. If an item appears on more than one statement, place a check mark in every applicable column.

Item	Income Statement	Statement of Changes in Stockholders' Equity	Balance Sheet	Statement of Cash Flows
Notes payable				
Beginning common stock				
Service revenue				
Utility expense				
Cash from stock issue				
Operating activities				
For the period ended (date)				
Net income				
Investing activities				
Net loss				
Ending cash balance				
Salary expense				
Consulting revenue				
Dividends				
Financing activities				
Ending common stock				
Interest expense				
As of (date)				
Land				
Beginning cash balance				

LO 2, 3, 5, 6
excel

Problem 1-30 *Preparing financial statements for two complete accounting cycles*

Webster Consulting experienced the following transactions for 2012, its first year of operations, and 2013. *Assume that all transactions involve the receipt or payment of cash.*

Transactions for 2012

CHECK FIGURES

b. Net Income 2012: $13,000

b. Retained Earnings 2013: $33,500

1. Acquired $20,000 by issuing common stock.
2. Received $35,000 cash for providing services to customers.
3. Borrowed $25,000 cash from creditors.
4. Paid expenses amounting to $22,000.
5. Purchased land for $30,000 cash.

Transactions for 2013

Beginning account balances for 2013 are:

Cash	$28,000
Land	30,000
Notes payable	25,000
Common stock	20,000
Retained earnings	13,000

1. Acquired an additional $24,000 from the issue of common stock.
2. Received $95,000 for providing services.
3. Paid $15,000 to creditors to reduce loan.
4. Paid expenses amounting to $71,500.
5. Paid a $3,000 dividend to the stockholders.
6. Determined that the market value of the land is $47,000.

Required

a. Write an accounting equation, and record the effects of each accounting event under the appropriate headings for each year. Record the amounts of revenue, expense, and dividends in the Retained Earnings column. Provide appropriate titles for these accounts in the last column of the table.

b. Prepare an income statement, statement of changes in stockholders' equity, year-end balance sheet, and statement of cash flows for each year.

c. Determine the amount of cash that is in the retained earnings account at the end of 2012 and 2013.

d. Examine the balance sheets for the two years. How did assets change from 2012 to 2013?

e. Determine the balance in the Retained Earnings account immediately after Event 2 in 2012 and in 2013 are recorded.

Problem 1-31 *Interrelationships among financial statements*

LO 2, 3, 5, 6

CHECK FIGURE

a. Net Income: $6,000
Total Assets: $59,000

Gofish Enterprises started the 2012 accounting period with $50,000 of assets (all cash), $18,000 of liabilities, and $4,000 of common stock. During the year, Gofish earned cash revenues of $38,000, paid cash expenses of $32,000, and paid a cash dividend to stockholders of $2,000. Gofish also acquired $15,000 of additional cash from the sale of common stock and paid $10,000 cash to reduce the liability owed to a bank.

Required

a. Prepare an income statement, statement of changes in stockholders' equity, period-end balance sheet, and statement of cash flows for the 2012 accounting period. (*Hint:* Determine the amount of beginning retained earnings before considering the effects of the current period events. It also might help to record all events under an accounting equation before preparing the statements.)

b. Determine the percentage of total assets that were provided by creditors, investors, and retained earnings.

LO 4

Problem 1-32 *Classifying events as asset source, use, or exchange*

The following unrelated events are typical of those experienced by business entities.

1. Acquire cash by issuing common stock.
2. Purchase land with cash.
3. Purchase equipment with cash.
4. Pay monthly rent on an office building.
5. Hire a new office manager.
6. Borrow cash from a bank.
7. Pay a cash dividend to stockholders.
8. Pay cash for operating expenses.
9. Pay an office manager's salary with cash.
10. Receive cash for services that have been performed.
11. Pay cash for utilities expense.
12. Acquire land by accepting a liability (financing the purchase).
13. Pay cash to purchase a new office building.
14. Discuss plans for a new office building with an architect.
15. Repay part of a bank loan.

Required

Identify each of the events as an asset source, use, or exchange transaction. If an event would not be recorded under generally accepted accounting principles, identify it as not applicable (NA). Also indicate for each event whether total assets would increase, decrease, or remain unchanged. Organize your answer according to the following table. The first event is shown in the table as an example.

Event No.	Type of Event	Effect on Total Assets
1	Asset source	Increase

LO 6

Problem 1-33 *Recording the effect of events in a horizontal statements model*

Texas Corporation experienced the following transactions during 2012.

1. Paid a cash dividend to the stockholders.
2. Acquired cash by issuing additional common stock.
3. Signed a contract to perform services in the future.
4. Performed services for cash.
5. Paid cash expenses.
6. Sold land for cash at an amount equal to its cost.
7. Borrowed cash from a bank.
8. Determined that the market value of the land is higher than its historical cost.

Required

Use a horizontal statements model to show how each event affects the balance sheet, income statement, and statement of cash flows. Indicate whether the event increases (I), decreases (D), or does not affect (NA) each element of the financial statements. Also, in the Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first transaction is shown as an example.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Cash	+	Land	=	N. Pay	+	C. Stock.	+	Ret. Ear.	Rev.	−	Exp.	=	Net Inc.	
1.	D	+	NA	=	NA	+	NA	+	D	NA	−	NA	=	NA	D FA

Problem 1-34 *Recording events in a horizontal statements model*

LO 5, 6

Cooley Company was started on January 1, 2012, and experienced the following events during its first year of operation.

CHECK FIGURES

a. Net Income: $3,000

e. Net Cash Flow from Operating Activities: $3,000

1. Acquired $30,000 cash from the issue of common stock.
2. Borrowed $40,000 cash from National Bank.
3. Earned cash revenues of $48,000 for performing services.
4. Paid cash expenses of $45,000.
5. Paid a $1,000 cash dividend to the stockholders.
6. Acquired an additional $20,000 cash from the issue of common stock.
7. Paid $10,000 cash to reduce the principal balance of the bank note.
8. Paid $53,000 cash to purchase land.
9. Determined that the market value of the land is $75,000.

Required

a. Record the preceding transactions in the horizontal statements model. Also, in the Cash Flows column, classify the cash flows as operating activities (OA), investing activities (IA), or financing activities (FA). The first event is shown as an example.

Event No.	Balance Sheet									Income Statement					Statement of Cash Flows
	Cash	+	Land	=	N. Pay	+	C. Stock.	+	Ret. Ear.	Rev.	−	Exp.	=	Net Inc.	
1.	30,000	+	NA	=	NA	+	30,000	+	NA	NA	−	NA	=	NA	30,000 FA

b. Determine the amount of total assets that Cooley would report on the December 31, 2012, balance sheet.

c. Identify the asset source transactions and related amounts for 2012.

d. Determine the net income that Cooley would report on the 2012 income statement. Explain why dividends do not appear on the income statement.

e. Determine the net cash flows from operating activities, financing activities, and investing activities that Cooley would report on the 2012 statement of cash flows.

f. Determine the percentage of assets that were provided by investors, creditors, and retained earnings.

g. What is the balance in the Retained Earnings account immediately after Event 3 is recorded?

ANALYZE, THINK, COMMUNICATE

ATC 1-1 Business Applications Case *Understanding real-world annual reports*

Required

Use the Target Corporation's annual report in Appendix B to answer the following questions. Note that net income and net earnings are synonymous terms.

Target Corporation

a. What was Target's net income for 2009?

b. Did Target's net income increase or decrease from 2008 to 2009, and by how much?

c. What was Target's accounting equation for 2009?

d. Which of the following had the largest percentage change from 2008 to 2009: net sales, cost of sales, or selling, general, and administrative expenses? Show all computations.

ATC 1-2 Group Assignment *Missing information*

The following selected financial information is available for HAS, Inc. Amounts are in millions of dollars.

Income Statements	2014	2013	2012	2011
Revenue	$ 860	$1,520	$ (a)	$1,200
Cost and expenses	(a)	(a)	(2,400)	(860)
Income from continuing operations	(b)	450	320	(a)
Unusual items	-0-	175	(b)	(b)
Net income	$ 20	$ (b)	$ 175	$ 300
Balance Sheets				
Assets				
Cash and marketable securities	$ 350	$1,720	$ (c)	$ 940
Other assets	1,900	(c)	2,500	(c)
Total assets	2,250	$2,900	$ (d)	$3,500
Liabilities	$ (c)	$ (d)	$1,001	$ (d)
Stockholders' equity				
Common stock	880	720	(e)	800
Retained earnings	(d)	(e)	800	(e)
Total stockholders' equity	1,520	1,345	(f)	2,200
Total liabilities and stockholders' equity	$2,250	$ (f)	$3,250	$3,500

Required

a. Divide the class into groups of four or five students each. Organize the groups into four sections. Assign Task 1 to the first section of groups, Task 2 to the second section, Task 3 to the third section, and Task 4 to the fourth section.

Group Tasks

(1) Fill in the missing information for 2011.

(2) Fill in the missing information for 2012.

(3) Fill in the missing information for 2013.

(4) Fill in the missing information for 2014.

b. Each section should select two representatives. One representative is to put the financial statements assigned to that section on the board, underlining the missing amounts. The second representative is to explain to the class how the missing amounts were determined.

c. Each section should list events that could have caused the unusual items category on the income statement.

ATC 1-3 Research Assignment *Finding real-world accounting information*

This chapter introduced the basic four financial statements companies use annually to keep their stakeholders informed of their accomplishments and financial situation. Complete the requirements below using the most recent (20xx) financial statements available on the McDonald Corporation's website. Obtain the statements on the Internet by following the steps below. (The formatting of the company's website may have changed since these instructions were written.)

1. Go to www.mcdonalds.com.
2. Click on the "Corporate" link at the bottom of the page. (Most companies have a link titled "investors relations" that leads to their financial statements; McDonald's uses "corporate" instead.)
3. Click on the "INVESTORS" link at the top of the page.

4. Click on *"McDonald's 20xx Annual Report"* and then on *"20xx Financial Report."*
5. Go to the company's financial statements that begin on page 45 of the annual report.

Required

a. What was the company's net income in each of the last 3 years?
b. What amount of total assets did the company have at the end of the most recent year?
c. How much retained earnings did the company have at the end of the most recent year?
d. For the most recent year, what was the company's cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities?

ATC 1-4 Writing Assignment *Elements of financial statements defined*

Sam and his sister Blair both attend the state university. As a reward for their successful completion of the past year (Sam had a 3.2 GPA in business, and Blair had a 3.7 GPA in art), their father gave each of them 100 shares of **The Walt Disney Company** stock. They have just received their first annual report. Blair does not understand what the information means and has asked Sam to explain it to her. Sam is currently taking an accounting course, and she knows he will understand the financial statements.

Required

Assume that you are Sam. Write Blair a memo explaining the following financial statement items to her. In your explanation, describe each of the two financial statements and explain the financial information each contains. Also define each of the elements listed for each financial statement and explain what it means.

Balance Sheet
Assets
Liabilities
Stockholders' equity
Income Statement
Revenue
Expense
Net income