# HOSPITALITY ACCOUNTING IN ACTION

**THE NAVIGATOR ✓**

- Understand *Concepts for Review* ❑
- Read *Feature Story* ❑
- Scan *Study Objectives* ❑
- Read *Preview* ❑
- Read text and answer *Before You Go On*
  *p.* 7 ❑ *p.* 13 ❑ *p.* 20 ❑ *p.* 24 ❑
- Work *Demonstration Problem* ❑
- Review *Summary of Study Objectives* ❑
- Complete *Assignments* ❑

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

## CONCEPTS FOR REVIEW

**Before studying this chapter, you should know or, if necessary, review:**

**a.** How to use the study aids in this book. (Student Owner's Manual, pages x–xvi)

**b.** The nature of the special student supplements that accompany this textbook. (Student Owner's Manual, page viii)

**Concepts for Review** highlight concepts from your earlier reading that you need to understand before starting the new chapter.

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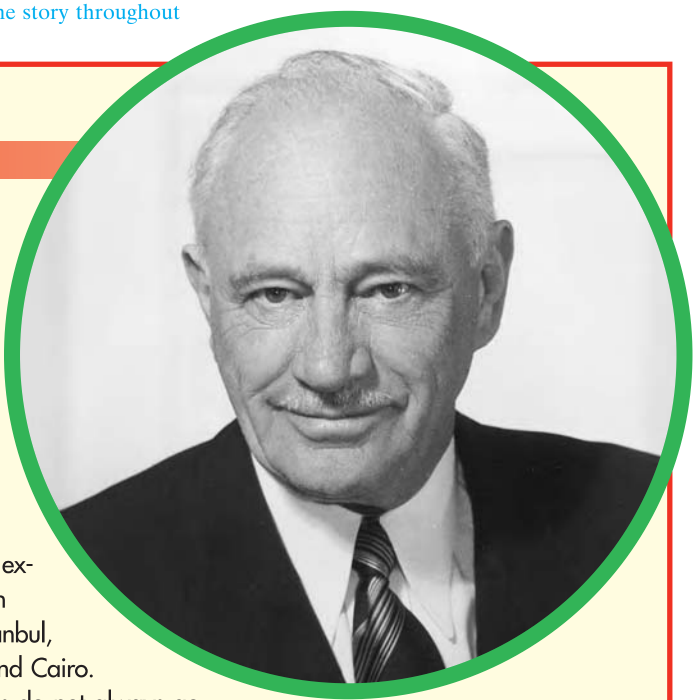
The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business. You will find references to the story throughout the chapter.

## FEATURE STORY



# From a Bank to a Hotel

The child of a Norwegian immigrant father and a German-American mother, Conrad N. Hilton had a strong belief in the American Dream. His philosophy and strength were derived from his faith in God, his belief in the brotherhood of man, his patriotic confidence in his country, and his conviction that there is a natural law that obliges all humankind to help those who are suffering, distressed, or destitute.

Hilton arrived in Cisco, Texas, in 1919 intending to buy a local bank. Instead he bought the Mobley Hotel, believing that he could utilize some of the hotel-keeping experience he had gained with his family in New Mexico. He constructed his first hotel, the Dallas Hilton, which opened on August 2, 1925.

Hilton successfully adapted to the economy of the American Great Depression in the 1930s. He expanded his empire by purchasing other hotels throughout the United States, including the Sir Francis Drake in San Francisco; The Plaza in New York; the Waldorf-Astoria Hotel in New York; the Stevens, currently known as the Chicago Hilton & Towers; and the Palmer House in Chicago. Internationally, Hilton developed his business by building hotels in such exotic locales as San Juan, Madrid, Istanbul, Havana, Berlin, and Cairo.

Although things do not always go as planned, and a bank instead became a hotel empire, lack of planning is often a recipe for disaster. Hilton did not become one of the largest hotel companies in the world without careful planning. **Hilton Hotels'** managers are constantly working to increase revenues and minimize costs. Careful consideration must be given to many types of decisions: what new products to provide, where to build the next hotel, how to finance current operations and expansion, where to locate, and whether to buy or lease properties.

The information needed for these decisions is provided by the company's accounting system. In addition, the company must report its results to the investors and creditors who provide it with the funds it needs to operate. A company communicates its past performances and its plans for the future in its annual report. A copy of the **Hilton Hotels Corporation's** 2001 Annual Report accompanies this text. In this book, you will learn how the accounting information in the annual report was determined, as well as how to use such information to make business decisions of all sorts.

Source: www.hrm.uh.edu/organizations/hallofhonor/cnhbiolong.pdf

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## STUDY OBJECTIVES

**After studying this chapter, you should be able to**

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

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

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## PREVIEW OF CHAPTER 1

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

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

**ACCOUNTING IN ACTION**

| What Is Accounting? | The Building Blocks of Accounting | Using the Building Blocks | Financial Statements |
|---|---|---|---|
| • Who uses accounting data<br>• Brief history of accounting<br>• Bookkeeping and accounting<br>• Accounting and you | • Ethics—a fundamental business concept<br>• Generally accepted accounting principles<br>• Assumptions<br>• Basic accounting equation | • Transaction analysis<br>• Summary of transactions | • Income statement<br>• Retained earnings statement<br>• Balance sheet<br>• Statement of cash flows |

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

# WHAT IS ACCOUNTING?

**STUDY OBJECTIVE 1**

Explain what accounting is.

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

**Accounting** is an information system that **identifies, records**, and **communicates** the economic events of an organization to interested users. Let's take a closer look at these three activities.

1. **Identifying** economic events involves selecting the **economic activities relevant to a particular organization**. The sale of goods and services by the **Hilton Hotels Corporation**, the providing of services by **Disney**, the payment of wages by **The Club Corporation of America**, and the collection of ticket and broadcast money and the payment of expenses by major league sports teams are examples of economic events.
2. Once identified, economic events are **recorded** to provide a history of the organization's financial activities. Recording consists of keeping a **systematic, chronological diary of events**, measured in dollars and cents. In recording, economic events are also classified and summarized.
3. The identifying and recording activities are of little use unless the information is **communicated** to interested users. Financial information is communicated through **accounting reports**, the most common of which are called **financial statements**. To make the reported financial information meaningful, account-

ants report the recorded data in a standardized way. Information resulting from similar transactions is accumulated and totaled. For example, all sales transactions of the **Hilton Hotels Corporation** are accumulated over a certain period of time and reported as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

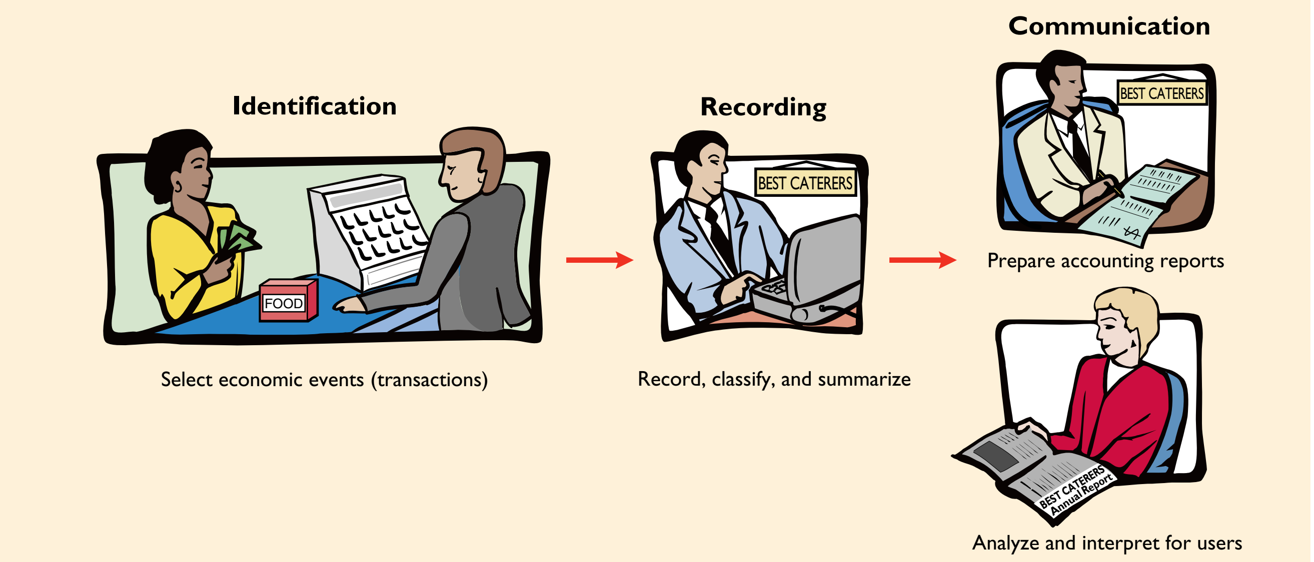
**References** throughout the chapter tie the accounting concepts you are learning to the story that opened the chapter.

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

The accounting process is summarized in Illustration 1-1.

**Illustration 1-1**

Accounting process




Accounting should consider the needs of the users of financial information. Therefore, you should know who these users are and something about their information needs.

## WHO USES ACCOUNTING DATA

**STUDY OBJECTIVE 2**

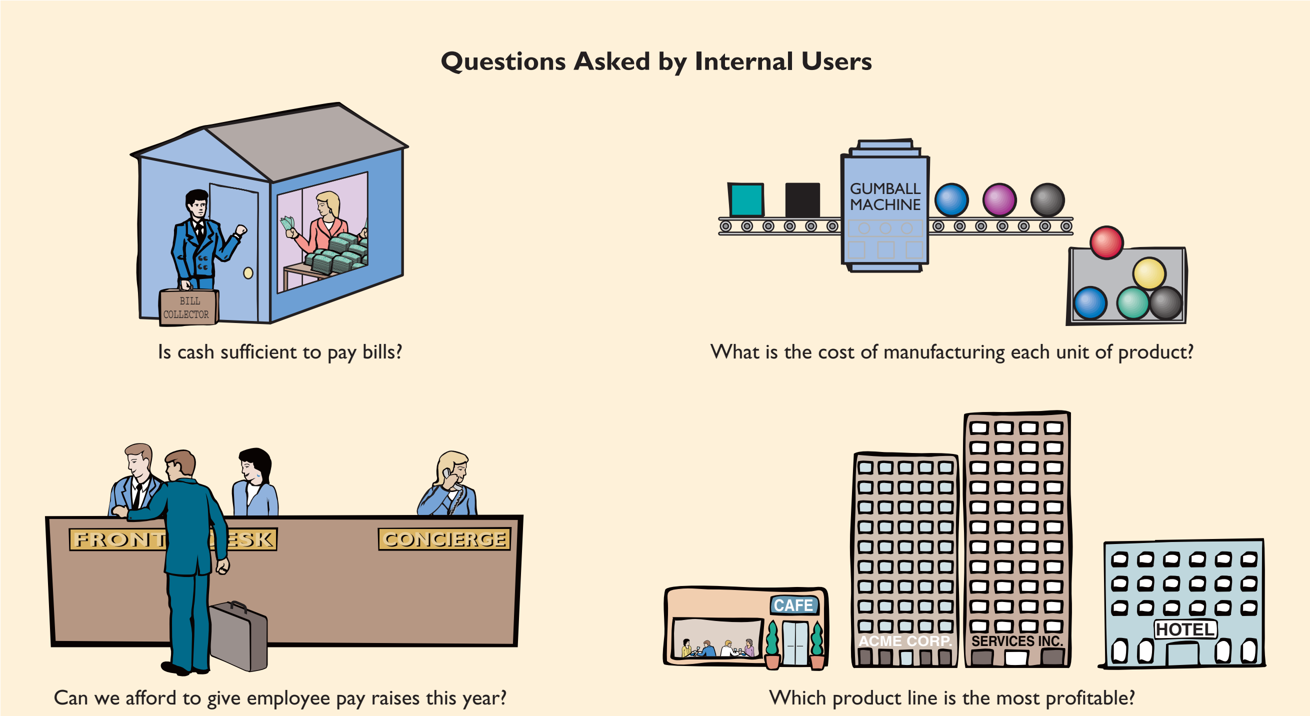
Identify the users and uses of accounting.

Because it communicates financial information, accounting is often called *the language of business.* The information that a user of financial information needs depends on the kinds of decisions that the user makes. The differences in the decisions divide the users of financial information into two broad groups: internal users and external users.

## Internal Users

**Internal users** of accounting information are managers who plan, organize, and run a business. These include **foodservice managers, housekeeping supervisors, rooms division managers, and others**. In running a business, managers must answer many important questions, as shown in Illustration 1-2.

**Illustration 1-2**
Questions asked by internal users




To answer these and other questions, users need detailed information on a timely basis. For internal users, accounting provides **internal reports**. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year. In addition, summarized financial information is presented in the form of financial statements.

## External Users

There are several types of **external users** of accounting information. **Investors** (owners) use accounting information to make decisions to buy, hold, or sell stock. **Creditors** such as suppliers and bankers use accounting information to evaluate the risks of granting credit or lending money. Some questions that may be asked by investors and creditors about a company are shown in Illustration 1-3.

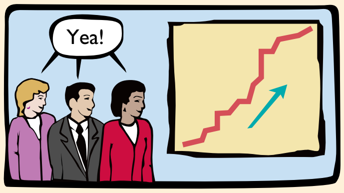
The information needs and questions of other external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with the tax laws. **Regulatory agencies**, such as the Securities and Exchange Commission and the Federal Trade Commission, want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company will continue to honor product warranties and support its product lines. **Labor unions** want to know whether the owners can pay increased wages and benefits. **Economic planners** use accounting information to forecast economic activity.

**HELPFUL HINT**
The IRS requires businesses to retain records that can be audited. Also, the Foreign Corrupt Practices Act requires public companies to keep records.

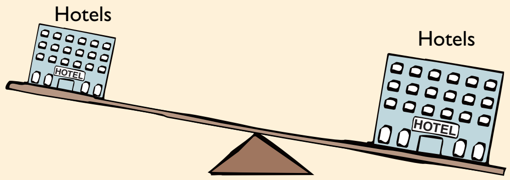
**Illustration 1-3**

Questions asked by external users

**Questions Asked by External Users**




Is the company earning satisfactory income?




How does the company compare in size and profitability with competitors?


Will the company be able to pay its debts as they come due?

## ACCOUNTING IN ACTION *International Insight*

In 1999, the number of berths (built-in beds on a cruise ship) provided by the cruise line industry in the North American market was more than 154,000 units. However, a cruise line is not simply a floating hotel. With all the amenities it has to offer, including spas, 24-hour foodservice, tennis courts, and casinos, cruises are closely scrutinized by the National Transportation Safety Board, Federal Maritime Commission, and the U.S. Coast Guard. The growth of this industry has resulted in increased regulations and greater capacity of new ships. This has created additional issues for the accounting personnel in the cruise line industry and the public accounting firms that service them. For example, ships need to be dry-docked for maintenance. If the next dry dock is estimated to be $2 million and is scheduled to be done in twenty months, then the accounting personnel should accrue $100,000 per month on the books. Therefore, the full $2 million will be recognized as a prepaid asset to be recorded at the time of dry docking.

*SOURCE:* Mitchell R. Less and Scott A. Mager (1999), "A Cruise Ship Is Not Just a Floating Hotel," *Bottomline*, 14(3), 15–20.

**Accounting in Action** examples illustrate important and interesting accounting situations in business.

## BRIEF HISTORY OF ACCOUNTING

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

With the advent of the **Industrial Age** in the nineteenth century and, later, the emergence of large corporations, a separation of the owners from the managers of businesses took place. As a result, the need to report the financial sta-

**E-Business Insights** provide examples of how e-business technology has influenced accounting and financial reporting.

tus of the enterprise became more important, to ensure that managers acted in accord with owners' wishes. Also, transactions between businesses became more complex, making it necessary to improve approaches for reporting financial information.

Our economy has now evolved into a post-industrial age—**the information age**—in which many "products" are information services. The computer has been the driver of the information age.

## ACCOUNTING IN ACTION e Business Insight

The surge of Internet usage has affected the hotel industry tremendously—so much so that there are new revenue and expense items that hotels did not have before. On one hand, revenues earned by hotels now include a fee that could either be charged separately or built into the room cost for the use of the Internet, business center usage, and banquet facilities, which are associated with convention services and presentations. Other revenues also include rental and installation of equipment, computers, ethernet cards, hubs, patch cables, and even the set-up of mini-LAN systems. Expenses, on the other hand, include the cost of leasing lines, Internet provider fees, telephone charges, equipment leases, and wages and salary of hotel and contract personnel, to name a few.

*SOURCE:* Henry A. Weeks, "Internet Revenue and Expense," *Bottomline*, 15(4) (2000), 73–74.

## DISTINGUISHING BETWEEN BOOKKEEPING AND ACCOUNTING

Many individuals mistakenly consider bookkeeping and accounting to be the same. This confusion is understandable because the accounting process **includes the bookkeeping function**. However, accounting also includes much more. **Bookkeeping usually involves only the recording of economic events**. It is therefore just one part of the accounting process. In total, **accounting involves the entire process of identifying, recording, and communicating economic events**.

Accounting may be further divided into financial accounting and managerial accounting. **Financial accounting** is the field of accounting that provides economic and financial information for investors, creditors, and other external users. **Managerial accounting** provides economic and financial information for managers and other internal users. Financial accounting is covered in this textbook.

## ACCOUNTING AND YOU

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

**General management:** Imagine running a theme park, a major resort, a school, a foodservice facility, a **McDonald's** franchise. All general managers need to understand accounting data in order to make wise business decisions.

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

**Finance:** Do you want to be a controller, a chief financial officer, a food and beverage controller, a purchasing analyst? These fields rely heavily on accounting. In all of them you will regularly examine and analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.

**Real estate:** Have you ever considered hotel properties as real estate? When you decide to buy or sell properties, you will need to understand finance and real estate. Many hospitality programs, especially at the Master's degree level, offer courses in real estate. Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase? All these are questions that need answers.

Accounting is useful even for occupations you might think completely unrelated. If you become a doctor, a lawyer, a social worker, a teacher, an engineer, an architect, or an entrepreneur—you name it—a working knowledge of accounting is relevant. You will need to understand financial reports in any enterprise you are associated with.

## ACCOUNTING IN ACTION *Business Insight*

### *Help Wanted: Forensic CPAs*

Tom Taylor's job at the **FBI** has changed. He used to pack a .357 magnum; now he wields a no. 2 pencil and a notebook computer. Taylor, age 37, for two years an FBI agent, is a forensic accountant, somebody who sniffs through company books to ferret out white-collar crime. Demand for this service has surged in the past few years. In one recent year, a recruiter for San Diego's **Robert Half International**, a headhunting firm, had requests for more than 1,000 such snoops.


Qualifications: A CPA with FBI, IRS, or similar government experience. Interestingly, despite its macho image, the FBI has long hired mostly accountants and lawyers as agents.

## BEFORE YOU GO ON...

*Before You Go On* questions at the end of major text sections offer an opportunity to stop and reexamine the key points you have studied.

### REVIEW IT

1. What is accounting?
2. What is meant by analysis and interpretation?
3. Who uses accounting information? Identify specific internal and external users of accounting information.
4. To whom are the origins of accounting generally attributed?
5. What is the difference between bookkeeping and accounting?
6. How can you use your accounting knowledge?

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## THE BUILDING BLOCKS OF ACCOUNTING

Every profession develops a body of theory consisting of principles, assumptions, and standards. Accounting is no exception. Just as a doctor follows certain standards in treating a patient's illness, an accountant follows certain standards in reporting financial information. For these standards to work, a fundamental business concept is followed—ethical behavior.

## ETHICS—A FUNDAMENTAL BUSINESS CONCEPT

**STUDY OBJECTIVE 3**

Understand why ethics is a fundamental business concept.

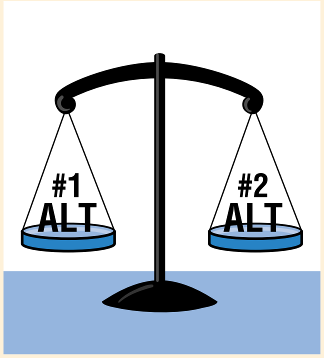
Wherever you make your career—whether in accounting, marketing, hotel or foodservice management, finance, or elsewhere—your actions will affect other people and organizations. The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Imagine trying to carry on a business or invest money if you could not depend on the individuals you deal with to be honest. If managers, customers, investors, co-workers, and creditors all consistently lied, effective communication and economic activity would be impossible. Information would have no credibility.

Fortunately, most individuals in business are ethical. Their actions are both legal and responsible, and they consider the organization's interests in their decision making. However, sometimes public officials and business executives act unethically. For example, the **Enron** board waived Enron's code of ethics where an executive created questionable partnerships; a trader with **Salomon Brothers** improperly overbid in auctions of U.S. Treasury bonds; **World Com** continued acquiring companies including MCI, MFS, and UUNET, until the 75 acquisitions were unable to function well together.

To sensitize you to ethical situations and to give you practice at solving ethical dilemmas, we have included in the book three types of ethics materials in certain chapters: (1) marginal notes that provide helpful hints for developing ethical sensitivity, (2) Ethics in Accounting boxes that highlight ethics situations and issues, and (3) at the end of the chapter, an ethics case simulating a business situation. In the process of analyzing these ethics cases and your own ethical experiences, you should apply the three steps outlined in Illustration 1-4.

**Illustration 1-4**

Steps in analyzing ethics cases




**Solving an Ethical Dilemma**

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

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

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

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

**STUDY OBJECTIVE 4**

Explain the meaning of generally accepted accounting principles and the cost principle.

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

Two organizations are primarily responsible for establishing generally accepted accounting principles. The first is the **Financial Accounting Standards Board (FASB)**. This private organization establishes broad reporting standards of general applicability as well as specific accounting rules. The second standards-setting group is the **Securities and Exchange Commission (SEC)**. The SEC is a governmental agency that requires companies to file financial reports following generally accepted accounting principles. In situations where no principles exist, the SEC often mandates that certain guidelines be used. In general, the FASB and the SEC work hand in hand to assure that timely and useful accounting principles are developed.

One important principle is the **cost principle**, which states that assets should be recorded at their cost. **Cost is the value exchanged at the time something is acquired**. If you buy a house today, the cost is the amount you pay for it, say $200,000. If you sell the house in two years for $230,000, the sales price is its **market value**—the value determined by the market for homes at that time. At the time of acquisition, cost and fair market value are the same. In subsequent periods, cost and fair market value may vary, **but the cost amount continues to be used in the accounting records**.

To see the importance of the cost principle, consider the following example. At one time, **Greyhound Corporation** had 128 bus stations nationwide that cost approximately $200 million. The current market value of the stations is now close to $1 billion. But, until the bus stations are actually sold, estimates of their market values are subjective—they are informed estimates. So, under the cost principle, the bus stations are recorded and reported at $200 million, not $1 billion.

As the Greyhound example indicates, cost has an important advantage over other valuations: Cost is **reliable**. The values exchanged at the time something is acquired generally can be **objectively measured** and can be **verified**. Critics argue that cost is often not relevant and that market values provide more useful information. Despite this shortcoming, cost continues to be used in the financial statements because of its reliability.

**INTERNATIONAL NOTE**

The standards-setting processes in Canada, Mexico, and the United States are similar in most respects. All three have relatively open deliberations on new rules, and they support efforts to follow international standards. The use of similar accounting principles within North America has implications for the success of the North American Free Trade Agreement (NAFTA).

**ALTERNATIVE TERMINOLOGY**

The cost principle is often referred to as the *historical cost principle.*

## ASSUMPTIONS

In developing generally accepted accounting principles, certain basic assumptions are made. These assumptions provide a foundation for the accounting process. Two main assumptions are the monetary unit assumption and the economic entity assumption.

**STUDY OBJECTIVE 5**

Explain the meaning of the monetary unit assumption and the economic entity assumption.

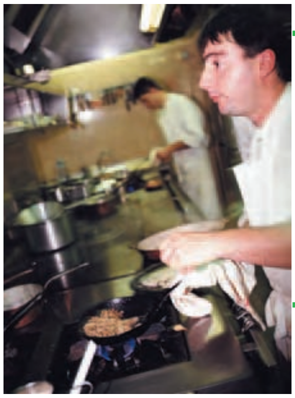
### *Monetary Unit Assumption*

The **monetary unit assumption** requires that only transaction data that can be expressed in terms of money be included in the accounting records. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to applying the cost principle discussed earlier. This assumption does prevent some relevant information from being included in the accounting records. For example, the health of the owner, the quality of service, and the morale of employees would not be included because they cannot be quantified in terms of money.

**An important part of the monetary unit assumption is the added assumption that the unit of measure remains sufficiently constant over time.** However, the assumption of a stable monetary unit has been challenged because of the significant decline in the purchasing power of the dollar. For example, what used to cost $1.00 in 1960 costs more than $4.00 in 2004. In such situations, adding, subtracting, or comparing 1960 dollars with 2004 dollars is highly questionable. The profession has recognized this problem and encourages companies to disclose the effects of changing prices.

### *Economic Entity Assumption*

**An economic entity can be any organization or unit in society.** It may be a business enterprise (such as **Marriott International, Inc.**), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Sally Rider, owner of Sally's Boutique, should keep her personal living costs separate from the expenses of the boutique. **Disney's Parks and Resorts** and its Studio Entertainment are segregated into separate economic entities for accounting purposes.



## ACCOUNTING IN ACTION *Ethics Insight*

A 400-seat independently owned restaurant in Irvine, California, was cited for alleged minimum-wage violations and failure to itemize payroll deductions on 395 incidents during a one-year auditing period. In addition, the restaurant had not provided workers' compensation insurance for 28 employees and owed $170,106 in back wages and overtime. The Labor Standards Enforcement Division slapped a fine of more than $300,000 on the owners.

*SOURCE:* "400-Seat-Operator Hit with $300K in Fines, Vows Appeal," *Nation's Restaurant News*, 34(7) (February, 14, 2000), 40.

We will generally discuss the economic entity assumption in relation to a business enterprise, which may be organized as a proprietorship, partnership, or corporation.

**HELPFUL HINT**
Approximately 70 percent of U.S. companies are proprietorships; however, they account for only 6.5 percent of gross revenues. Corporations are approximately 19 percent of all companies, but account for 90 percent of the revenues. Obviously, proprietorships, though numerous, tend to be small.

***PROPRIETORSHIP.*** A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (travel agencies, beauty salons, and interior decorators), farms, and small retail stores (cigar specialty shops, ice-cream parlors, and sandwich shops) are often sole proprietorships. **Usually only a relatively small amount of money (capital) is necessary to start in business as a proprietorship. The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.** There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

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

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

Although the combined number of proprietorships and partnerships in the United States is more than four times the number of corporations, the revenue produced by corporations is nine times greater. Most of the largest hospitality enterprises in the United States—for example, **Hilton Hotels**, **Starwood**, **Marriott**, and the **Walt Disney Company**—are corporations.

## BASIC ACCOUNTING EQUATION

**STUDY OBJECTIVE 6**

State the basic accounting equation, and explain the meaning of assets, liabilities, and stockholders' equity.

Other essential building blocks of accounting are the categories into which economic events are classified. The two basic elements of a business are what it owns and what it owes. **Assets** are the resources owned by a business. For example, the 2001 year-end figures showed **Marriott** having total assets of approximately $9,107 million. Liabilities and stockholders' equity are the rights or claims against these resources. Thus, a company such as **Marriott** that has $9,107 million of assets also has $9,107 million of claims against those assets. Claims of those to whom money is owed (creditors) are called **liabilities**. Claims of owners are called **stockholders' equity**. For example, **Marriott** has liabilities of $5,629 million and stockholders' equity of $3,487 million. This relationship of assets, liabilities, and stockholders' equity can be expressed as an equation as shown in Illustration 1-5.

Assets = Liabilities + Stockholders' Equity

**Illustration 1-5**

The basic accounting equation

This relationship is referred to as the **basic accounting equation**. Assets must equal the sum of liabilities and stockholders' equity. Because creditors' claims must be paid before ownership claims if a business is liquidated, liabilities are shown before stockholders' equity in the basic accounting equation.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner delicatessen as well as to a giant corporation such as **Carlson Companies Inc.,** which owns various hotel brands and also **TGI Friday's**. The equation provides the **underlying framework** for recording and summarizing the economic events of a business enterprise.

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

### *Assets*

As noted above, **assets** are resources owned by a business. They are used in carrying out such activities as production, consumption, and exchange. The common characteristic possessed by all assets is the capacity to provide future services or benefits. In a business enterprise, that service potential or future economic benefit eventually results in cash inflows (receipts) to the enterprise.

For example, the enterprise Campus Pizza owns a delivery truck that provides economic benefits from its use in delivering pizzas. Other assets of Campus Pizza are tables, chairs, jukebox, cash register, oven, mugs and silverware, and, of course, cash.

### *Liabilities*

**Liabilities** are claims against assets. That is, **liabilities are existing debts and obligations**. For example, businesses of all sizes usually borrow money and purchase merchandise on credit. Campus Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts**

**payable**. Campus Pizza also has a **note payable** to First National Bank for the money borrowed to purchase the delivery truck. Campus Pizza may also have **wages payable** to employees and **sales and real estate taxes payable** to the local government. All of these persons or entities to whom Campus Pizza owes money are its **creditors**.

Most claims of creditors attach to the entity's **total assets** rather than to the specific assets provided by the creditor. Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid before ownership claims.

## Stockholders' Equity

The ownership claim on total assets is known as **stockholders' equity**. It is equal to total assets minus total liabilities. Here is why: The assets of a business are supplied or claimed by either creditors or stockholders. To determine what belongs to stockholders, we therefore subtract creditors' claims—the liabilities—from assets. The remainder—stockholders' equity—is the stockholders' claim on the assets of the business. It is often referred to as **residual equity** (that is, the equity "left over" after creditors' claims are satisfied). The stockholders' equity section of a corporation's balance sheet consists of (1) paid-in (contributed) capital and (2) retained earnings (earned capital).

***PAID-IN CAPITAL.*** **Paid-in capital** is the term used to describe the total amount paid in by stockholders. The principal source of paid-in capital is the investment of cash and other assets in the corporation by stockholders in exchange for capital stock. Corporations may issue several classes of stock, but the stock representing ownership interest is common stock.

***RETAINED EARNINGS.*** The **retained earnings** section of the balance sheet is determined by three items: revenues, expenses, and dividends.

***Revenues.*** **Revenues** are the gross increases in stockholders' equity resulting from business activities entered into for the purpose of earning income. Generally, revenues result from the sale of merchandise, the performance of services, the rental of property, and the lending of money.

Revenues usually result in an increase in an asset. They may arise from different sources and are identified by various names depending on the nature of the business. Campus Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales. Other titles for and sources of revenue common to many businesses are: sales, fees, services, commissions, interest, dividends, royalties, and rent.

**HELPFUL HINT**
The effect of revenues is positive—an increase in stockholders' equity coupled with an increase in assets or a decrease in liabilities.

***Expenses.*** **Expenses** are the decreases in stockholders' equity that result from operating the business. They are the cost of assets consumed or services used in the process of earning revenue. Expenses represent actual or expected cash outflows (payments). Like revenues, expenses take many forms and are identified by various names depending on the type of asset consumed or service used. For example, Campus Pizza recognizes the following types of expenses: cost of ingredients (meat, flour, cheese, tomato paste, mushrooms, etc.); cost of beverages; wages expense; utilities expense (electric, gas, and water expense); telephone expense; delivery expense (gasoline, repairs, licenses, etc.); supplies expense (napkins, detergents, aprons, etc.); rent expense; interest expense; and property tax expense. When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

**HELPFUL HINT**
The effect of expenses is negative—a decrease in stockholders' equity coupled with a decrease in assets or an increase in liabilities.

***Dividends.*** When a company is successful, it generates net income. **Net income** represents an increase in net assets which are then available to distribute to stockholders. The distribution of cash or other assets to stockholders is called a **dividend**. Dividends reduce retained earnings. However, dividends are not an expense of a corporation. A corporation first determines its revenues and expenses and then computes net income or **net loss**. At this point, a corporation may decide to distribute a dividend.

In summary, the principal sources (increases) of stockholders' equity are (1) investments by stockholders and (2) revenues from business operations. In contrast, reductions (decreases) in stockholders' equity are a result of (1) expenses and (2) dividends. These relationships are shown in Illustration 1-6.

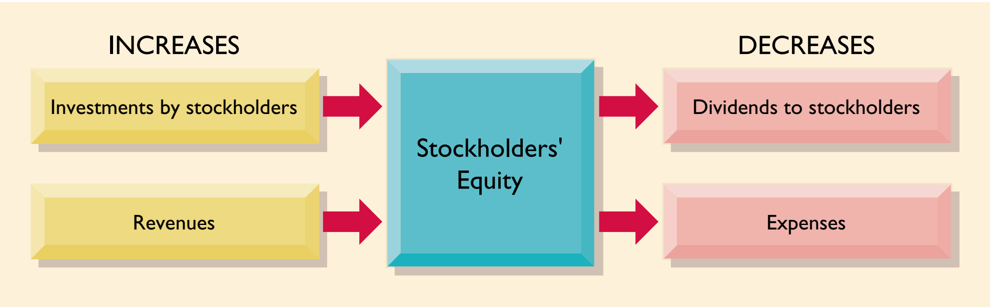



**Illustration 1-6**

Increases and decreases in stockholders' equity

## BEFORE YOU GO ON...

*REVIEW IT*

1. Why is ethics a fundamental business concept?
2. What are generally accepted accounting principles? Give an example.
3. Explain the monetary unit and the economic entity assumptions.
4. The accounting equation is: Assets = Liabilities + Stockholders' Equity. Replacing the words in that equation with dollar amounts, what is **Hilton's** accounting equation at December 31, 2001? (The answer to this question is provided on page 32.)
5. What are assets, liabilities, and stockholders' equity?

**Review It** questions marked with this icon require that you use **Hilton's** 2001 Annual Report.

Image rights not available

*DO IT*

Classify the following items as issuance of stock (I), dividends (D), revenues (R), or expenses (E). Then indicate whether the following items increase or decrease stockholders' equity: (1) rent expense, (2) service revenue, (3) dividends, and (4) salaries expense.

**Do It** exercises give you immediate practice of the material just covered.

*ACTION PLAN*

- Review the rules for changes in stockholders' equity: Investments and revenues increase stockholders' equity. Expenses and dividends decrease stockholders' equity.
- Understand the sources of revenue: the sale of merchandise, performance of services, rental of property, and lending of money.
- Understand what causes expenses: the consumption of assets or services.
- Recognize that dividends are distributions of cash or other assets to stockholders.

*SOLUTION*

1. Rent expense is classified as an expense (E); it decreases stockholders' equity.
2. Service revenue is classified as revenue (R); it increases stockholders' equity.
3. Dividends is classified as dividends (D); it decreases stockholders' equity.
4. Salaries expense is classified as an expense (E); it decreases stockholders' equity.

*Related exercise material: 1-1, 1-2, 1-3, 1-4, 1-5, 1-6, 1-7, and 1-8.*

THE NAVIGATOR

## USING THE BUILDING BLOCKS

**STUDY OBJECTIVE 7**

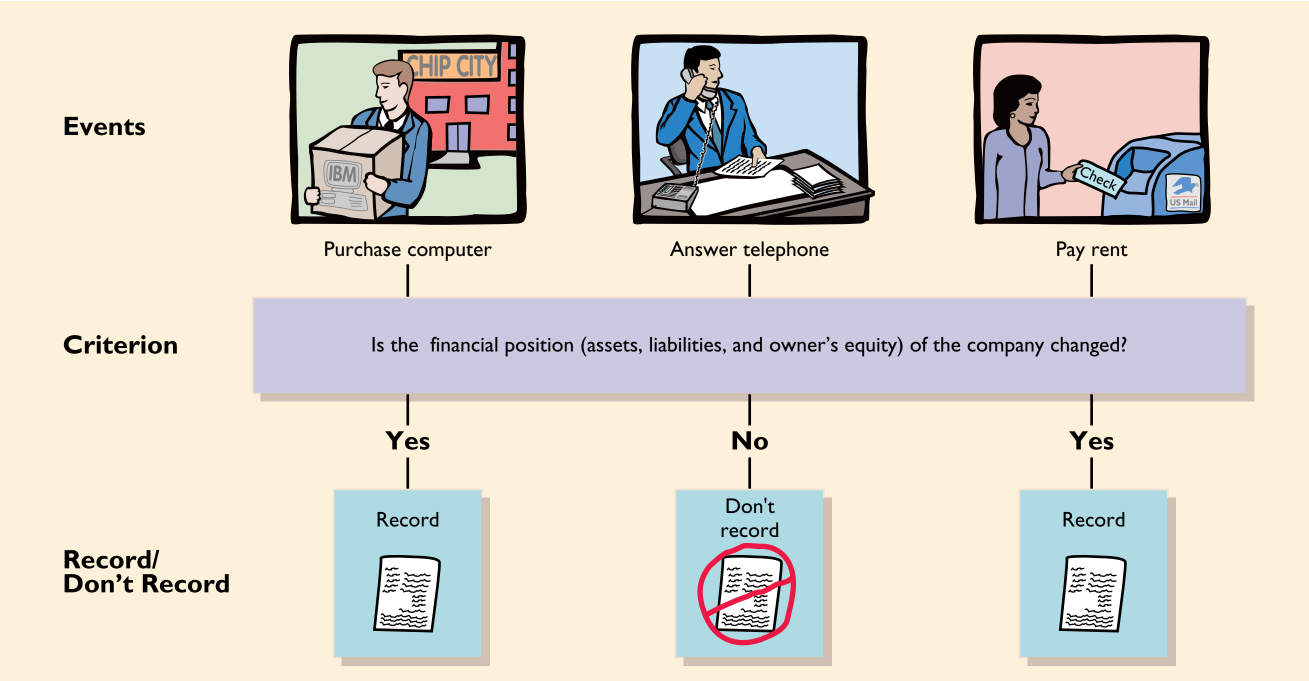
Analyze the effects of business transactions on the basic accounting equation.

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

A company may carry on many activities that do not in themselves represent business transactions. Hiring employees, answering the telephone, talking with customers, and placing orders for merchandise are examples. Some of these activities, however, may lead to business transactions: Employees will earn wages, and merchandise will be delivered by suppliers. Each event must be analyzed to find out if it has an effect on the components of the basic accounting equation. If it does, it will be recorded in the accounting process. Illustration 1-7 demonstrates the transaction identification process.

**Illustration 1-7**

Transaction identification process




The equality of the basic equation must be preserved. Therefore, each transaction must have a dual effect on the equation. For example, if an asset is increased, it must be offset by one or more of the following:

1. Decrease in another asset
2. Increase in a specific liability
3. Increase in owner's/stockholders' equity

It follows that two or more items could be affected when an asset is increased. For example, as one asset is increased $10,000, another asset could decrease $6,000 and a specific liability could increase $4,000. Note also that any change in an individual liability or ownership claim is subject to similar analysis.

## TRANSACTION ANALYSIS

The following examples are business transactions for a new computer programming business during its first month of operations. You will want to study these transactions until you are sure you understand them. They are not difficult, but they are important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential for an understanding of accounting.

### *Transaction (1). Investment by Stockholders*

Ray and Barbara Neal decide to open a catering service that they incorporate as Best Caterers, Inc. They invest $15,000 cash in the business in exchange for $15,000 of common stock. The common stock indicates the ownership interest that the Neals have in Best Caterers, Inc. The transaction results in an equal increase in both assets and stockholders' equity. In this case, there is an increase in the asset Cash of $15,000, and an increase in Common Stock of $15,000.

The effect of this transaction on the basic equation is shown below. Recorded to the right of Common Stock is the reason why stockholders' equity changed (i.e., investment).

| | Assets | = | Liabilities | + | Stockholders' Equity | |
|---|---|---|---|---|---|---|
| | Cash | = | | | Common Stock | |
| (1) | **+$15,000** | **=** | | | **+$15,000** | **Investment** |

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in stockholders' equity is indicated, to make clear that the increase is an investment rather than revenue from operations. Why does this matter? Because investments by stockholders do not represent revenues; they are excluded in determining net income. Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations. Additional investments (i.e., investments made by stockholders after the corporation has been initially formed) have the same effect on stockholders' equity as the initial investment.

### *Transaction (2). Purchase of Equipment for Cash*

Best Caterers, Inc. purchases computer equipment for $7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets is changed: Cash is decreased $7,000, and the asset Equipment is increased $7,000. The specific effect of this transaction and the cumulative effect of the first two transactions are:

| | | Assets | | | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|
| | | Cash | + | Equipment | = | | | Common Stock |
| | Old Bal. | $15,000 | | | | | | $15,000 |
| (2) | | **−7,000** | | **+$ 7,000** | | | | |
| | New Bal. | $ 8,000 | + | $ 7,000 | = | | | $15,000 |
| | | $15,000 | | | | | | |

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

## *Transaction (3). Purchase of Supplies on Credit*

Best Caterers, Inc. purchases for $1,600 from Acme Supply Company various supplies expected to last several months. Acme agrees to allow Best Caterers to pay this bill next month, in October. This transaction is often referred to as a purchase on account or a credit purchase. Assets are increased by the transaction because of the expected future benefits of using the paper and supplies, and liabilities are increased by the amount due Acme Company. The asset Supplies is increased $1,600, and the liability Accounts Payable is increased by the same amount. The effect on the equation is:

| | | **Assets** | | | | | = | **Liabilities** | + | **Stockholders' Equity** |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Cash | + | Supplies | + | Equipment | = | Accounts Payable | + | Common Stock |
| | Old Bal. | $8,000 | | | | $7,000 | | | | $15,000 |
| (3) | | | | **+$1,600** | | | | **+$1,600** | | |
| | New Bal. | $8,000 | + | $1,600 | + | $7,000 | = | $1,600 | + | $15,000 |
| | | | | $16,600 | | | | | $16,600 | |

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

## *Transaction (4). Services Rendered for Cash*

Best Caterers, Inc. receives $1,200 cash from customers for catering services it has provided. This transaction represents Best Caterers' principal revenue-producing activity. Recall that **revenue increases stockholders' equity**. Both assets and stockholders' equity are, therefore, increased. In this transaction, Cash is increased $1,200, and Retained Earnings is increased $1,200. The new balances in the equation are:

| | | **Assets** | | | | | = | **Liabilities** | + | **Stockholders' Equity** | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Cash | + | Supplies | + | Equipment | = | Accounts Payable | + | Common Stock | + | Retained Earnings | |
| | Old Bal. | $8,000 | | $1,600 | | $7,000 | | $1,600 | | $15,000 | | | |
| (4) | | **+1,200** | | | | | | | | | | **+1,200** | **Service Revenue** |
| | New Bal. | $9,200 | + | $1,600 | + | $7,000 | = | $1,600 | + | $15,000 | + | $1,200 | |
| | | | | $17,800 | | | | | | $17,800 | | | |

The two sides of the equation balance at $17,800. Note that stockholders' equity is increased when revenues are earned. The source of the increase in stockholders' equity is indicated as Service Revenue. Service revenue is included in determining Best Caterers, Inc's. net income.

## *Transaction (5). Purchase of Advertising on Credit*

Best Caterers, Inc. receives a bill for $250 from the *Daily News* for advertising the opening of its business but postpones payment of the bill until a later date. This transaction results in an increase in liabilities and a decrease in stockholders' equity. The specific items involved are Accounts Payable and Retained Earnings. The effect on the equation is:

| | Assets | | | | | = | Liabilities | + | Stockholders' Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + | Supplies | + | Equipment | = | Accounts Payable | + | Common Stock | + | Retained Earnings | |
| Old Bal. | $9,200 | | $1,600 | | $7,000 | | $1,600 | | $15,000 | | $1,200 | |
| (5) | | | | | | | +250 | | | | −250 | Advertising Expense |
| New Bal. | $9,200 | + | $1,600 | + | $7,000 | = | $1,850 | + | $15,000 | + | $ 950 | |
| | | | $17,800 | | | | | | $17,800 | | | |

The two sides of the equation still balance at $17,800. Observe that Retained Earnings is decreased when the expense is incurred, and the specific cause of the decrease (Advertising Expense) is noted. Expenses do not have to be paid in cash at the time they are incurred. When payment is made at a later date, the liability Accounts Payable will be decreased and the asset Cash will be decreased [see Transaction (8)]. The cost of advertising is considered an expense, as opposed to an asset, because the benefits have been used. This expense is included in determining net income.

## *Transaction (6). Services Rendered for Cash and Credit*

Best Caterers, Inc. provides catering services of $3,500 for customers. Cash of $1,500 is received from customers, and the balance of $2,000 is billed to customers on account. This transaction results in an equal increase in assets and stockholders' equity. Three specific items are affected: Cash is increased $1,500; Accounts Receivable is increased $2,000; and Retained Earnings is increased $3,500. The new balances are as follows:

| | Assets | | | | | | | = | Liabilities | + | Stockholders' Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + | Accounts Receivable | + | Supplies | + | Equipment | = | Accounts Payable | + | Common Stock | + | Retained Earnings | |
| Old Bal. | $ 9,200 | | | | $1,600 | | $7,000 | | $1,850 | | $15,000 | | $ 950 | |
| (6) | +1,500 | | +$2,000 | | | | | | | | | | +3,500 | Service Revenue |
| New Bal. | $10,700 | + | $2,000 | + | $1,600 | + | $7,000 | = | $1,850 | + | $15,000 | + | $4,450 | |
| | | | | | $21,300 | | | | | | $21,300 | | | |

Why increase Retained Earnings by $3,500 when only $1,500 has been collected? Because the inflow of assets resulting from the earning of revenues does not have to be in the form of cash. Remember that stockholders' equity is increased when revenues are earned; in Best Caterers' case revenues are earned when the service is provided. When collections on account are received at a later date, Cash will be increased and Accounts Receivable will be decreased [see Transaction (9)].

## *Transaction (7). Payment of Expenses*

Expenses paid in cash for September are store rent $600, salaries of employees $900, and utilities $200. These payments result in an equal decrease in assets and stockholders' equity. Cash is decreased $1,700 and Retained Earnings is decreased by the same amount. The effect of these payments on the equation is:

| | Assets | | | | = Liabilities + | Stockholders' Equity | | |
|---|---|---|---|---|---|---|---|---|
| | Cash | + Accounts Receivable | + Supplies | + Equipment | = Accounts Payable | + Common Stock | + Retained Earnings | |
| Old Bal. | $10,700 | $2,000 | $1,600 | $7,000 | $1,850 | $15,000 | $4,450 | |
| (7) | −1,700 | | | | | | −600 | Rent Expense |
| | | | | | | | −900 | Salaries Expense |
| | | | | | | | −200 | Utilities Expense |
| New Bal. | $ 9,000 + | $2,000 + | $1,600 + | $7,000 = | $1,850 + | $15,000 + | $2,750 | |
| | $19,600 | | | | $19,600 | | | |

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

### Transaction (8). Payment of Accounts Payable

Best Caterers, Inc. pays its *Daily News* advertising bill of $250 in cash. Remember that the bill was previously recorded [in Transaction (5)] as an increase in Accounts Payable and a decrease in Retained Earnings. Thus, this payment "on account" decreases the asset Cash by $250 and also decreases the liability Accounts Payable by $250. The effect of this transaction on the equation is:

| | Assets | | | | = Liabilities | + Stockholders' Equity | |
|---|---|---|---|---|---|---|---|
| | Cash | + Accounts Receivable | + Supplies | + Equipment | = Accounts Payable | + Common Stock | + Retained Earnings |
| Old Bal. | $9,000 | $2,000 | $1,600 | $7,000 | $1,850 | $15,000 | $2,750 |
| (8) | −250 | | | | −250 | | |
| New Bal. | $8,750 + | $2,000 + | $1,600 + | $7,000 = | $1,600 + | $15,000 + | $2,750 |
| | $19,350 | | | | $19,350 | | |

Observe that the payment of a liability related to an expense that has previously been incurred does not affect stockholders' equity. The expense was recorded in Transaction (5) and should not be recorded again. Neither Common Stock nor Retained Earnings changes as a result of this transaction.

### Transaction (9). Receipt of Cash on Account

The sum of $600 in cash is received from customers who have previously been billed for services [in Transaction (6)]. This transaction does not change total assets, but it changes the composition of those assets. Cash is increased $600 and Accounts Receivable is decreased $600. The new balances are:

| | Assets | | | | = Liabilities | + Stockholders' Equity | |
|---|---|---|---|---|---|---|---|
| | Cash | + Accounts Receivable | + Supplies | + Equipment | = Accounts Payable | + Common Stock | + Retained Earnings |
| Old Bal. | $8,750 | $2,000 | $1,600 | $7,000 | $1,600 | $15,000 | $2,750 |
| (9) | +600 | −600 | | | | | |
| New Bal. | $9,350 + | $1,400 + | $1,600 + | $7,000 = | $1,600 + | $15,000 + | $2,750 |
| | $19,350 | | | | $19,350 | | |

Note that a collection on account for services previously billed and recorded does not affect stockholders' equity. Revenue was already recorded in Transaction (6) and should not be recorded again.

### *Transaction (10). Dividends*

The corporation pays a dividend of $1,300 in cash to Ray and Barbara Neal, the stockholders of Best Caterers, Inc. This transaction results in an equal decrease in assets and stockholders' equity. Both Cash and Retained Earnings are decreased $1,300, as shown below.

| | Assets | | | | = | Liabilities | + | Stockholders' Equity | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | + Accounts Receivable | + Supplies | + Equipment | = | Accounts Payable | + | Common Stock | + | Retained Earnings |
| Old Bal. | $9,350 | $1,400 | $1,600 | $7,000 | | $1,600 | | $15,000 | | $2,750 |
| (10) | **−1,300** | | | | | | | | | **−1,300 Dividends** |
| New Bal. | $8,050 + | $1,400 + | $1,600 + | $7,000 | = | $1,600 | + | $15,000 | + | $1,450 |
| | $18,050 | | | | | $18,050 | | | | |

Note that the dividend reduces retained earnings, which is part of stockholders' equity. Dividends are not expenses. Like stockholders' investments, dividends are excluded in determining net income.

## SUMMARY OF TRANSACTIONS

The transactions of Best Caterers, Inc. are summarized in Illustration 1-8. The transaction number, the specific effects of the transaction, and the balances

**Illustration 1-8**

Tabular summary of Best Caterers, Inc. transactions

| | Assets | | | | | | | = | Liabilities | + | Stockholders' Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Transaction | Cash | + | Accounts Receivable | + | Supplies | + | Equipment | = | Accounts Payable | + | Common Stock | + | Retained Earnings | |
| (1) | +$15,000 | | | | | | | = | | + | $15,000 | | | **Investment** |
| (2) | −7,000 | | | | | | +$7,000 | | | | | | | |
| | 8,000 | | | | | + | 7,000 | = | | | 15,000 | | | |
| (3) | | | | | +$1,600 | | | | +$1,600 | | | | | |
| | 8,000 | | | + | 1,600 | + | 7,000 | = | 1,600 | + | 15,000 | | | |
| (4) | +1,200 | | | | | | | | | | | | +1,200 | **Service Revenue** |
| | 9,200 | | | + | 1,600 | + | 7,000 | = | 1,600 | + | 15,000 | + | 1,200 | |
| (5) | | | | | | | | | +250 | | | | −250 | **Advert. Expense** |
| | 9,200 | | | + | 1,600 | + | 7,000 | = | 1,850 | + | 15,000 | + | 950 | |
| (6) | +1,500 | | +$2,000 | | | | | | | | | | +3,500 | **Service Revenue** |
| | 10,700 | + | 2,000 | + | 1,600 | + | 7,000 | = | 1,850 | + | 15,000 | + | 4,450 | |
| (7) | −1,700 | | | | | | | | | | | | −600 | **Rent Expense** |
| | | | | | | | | | | | | | −900 | **Salaries Expense** |
| | | | | | | | | | | | | | −200 | **Utilities Expense** |
| | 9,000 | + | 2,000 | + | 1,600 | + | 7,000 | = | 1,850 | + | 15,000 | + | 2,750 | |
| (8) | −250 | | | | | | | | −250 | | | | | |
| | 8,750 | + | 2,000 | + | 1,600 | + | 7,000 | = | 1,600 | + | 15,000 | + | 2,750 | |
| (9) | +600 | | −600 | | | | | | | | | | | |
| | 9,350 | + | 1,400 | + | 1,600 | + | 7,000 | = | 1,600 | + | 15,000 | + | 2,750 | |
| (10) | −1,300 | | | | | | | | | | | | −1,300 | **Dividends** |
| | $ 8,050 | + | $1,400 | + | $1,600 | + | $7,000 | = | $1,600 | + | $15,000 | + | $1,450 | |
| | $18,050 | | | | | | | | $18,050 | | | | | |

after each transaction are indicated. The illustration demonstrates a number of significant facts:

1. Each transaction must be analyzed in terms of its effect on
   **(a)** the three components of the basic accounting equation.
   **(b)** specific types (kinds) of items within each component.
2. The two sides of the equation must always be equal.
3. The causes of each change in the stockholders' claim on assets must be indicated in the Common Stock and Retained Earnings columns.

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

## BEFORE YOU GO ON...

### *REVIEW IT*

1. What is an example of an external transaction? What is an example of an internal transaction?
2. If an asset increases, what are the three possible effects on the basic accounting equation?

### *DO IT*

A tabular analysis of the transactions made by Roberta Mendez & Co., a decorating consulting firm, for the month of August is shown below. Each increase and decrease in stockholders' equity is explained.

| | Assets | | | = | Liabilities | + | Stockholders' Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Cash** | + | **Office Equipment** | = | **Accounts Payable** | + | **Common Stock** | + | **Retained Earnings** | |
| 1. | +25,000 | | | | | | +25,000 | | | Investment |
| 2. | | | +7,000 | | +7,000 | | | | | |
| 3. | +8,000 | | | | | | | | +8,000 | Service Revenue |
| 4. | −850 | | | | | | | | −850 | Rent Expense |

Describe each transaction that occurred for the month.

### *ACTION PLAN*

- Analyze the tabular analysis to determine the nature and effect of each transaction.
- Keep the accounting equation always in balance.
- Remember that a change in an asset will require a change in another asset, a liability, or in stockholders' equity.

### *SOLUTION*

1. Stockholders purchased additional shares of stock for $25,000 cash.
2. The company purchased $7,000 of office equipment on credit.
3. The company received $8,000 of cash in exchange for services performed.
4. The company paid $850 for this month's rent.

*Related exercise material: 1-4, 1-5, 1-7, 1-8, and 1-9.*

THE NAVIGATOR

# FINANCIAL STATEMENTS

After transactions are identified, recorded, and summarized, four financial statements are prepared from the summarized accounting data:

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

**STUDY OBJECTIVE 8**

Understand what the four financial statements are and how they are prepared.

Each statement provides management, stockholders, and other interested parties with relevant financial data.

The financial statements of Best Caterers, Inc. and their interrelationships are shown in Illustration 1-9 (page 22). The statements are interrelated: **(1) Net income of $2,750 shown on the income statement is added to the beginning balance of retained earnings in the retained earnings statement. (2) Retained earnings of $1,450 at the end of the reporting period shown in the retained earnings statement is reported on the balance sheet. (3) Cash of $8,050 on the balance sheet is reported on the statement of cash flows.**

**HELPFUL HINT**
The income statement, retained earnings statement, and statement of cash flows are all for a *period* of time, whereas the balance sheet is for a *point* in time.

Also, every set of financial statements is accompanied by explanatory notes and supporting schedules that are an integral part of the statements. Examples of these notes and schedules are illustrated in later chapters of this textbook.

Be sure to carefully examine the format and content of each statement. The essential features of each are briefly described in the following sections.

**HELPFUL HINT**
There is only one group of notes for the whole set of financial statements, rather than separate sets of notes for each financial statement.

## INCOME STATEMENT

The primary focus of the income statement is to report the success or profitability of the company's operations over a specific period of time. For example, Best Caterers' income statement is dated "For the Month Ended September 30, 2004." It is prepared from the data appearing in the retained earnings column of Illustration 1-8. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

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

On the income statement, revenues are listed first, followed by expenses. Finally net income (or net loss) is determined. Although practice varies, we have chosen in our illustrations and homework solutions to list expenses in order of magnitude. Alternative formats for the income statement will be considered in later chapters.

Note that investment and dividend transactions between the stockholders and the business are not included in the measurement of net income. For example, the cash dividend from Best Caterers, Inc. was not regarded as a business expense, as explained earlier. This type of transaction is considered a reduction of retained earnings which causes a decrease in stockholders' equity.

## RETAINED EARNINGS STATEMENT

Best Caterers, Inc.'s retained earnings statement reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2004"). Data for the preparation of the retained earnings statement are obtained from the retained earnings column of the tabular summary (Illustration 1-8) and from the income statement in Illustration 1-9.

**Illustration 1-9**

Financial statements and their interrelationships

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

**HELPFUL HINT**
The four financial statements are prepared in the sequence shown for the following reasons: Net income is computed first and is needed to determine the ending balance in retained earnings. The ending balance in retained earnings is needed in preparing the balance sheet. The cash shown on the balance sheet is needed in preparing the statement of cash flows.

**HELPFUL HINT**
Note that final sums are double-underlined, and negative amounts are presented in parentheses.

**BEST CATERERS, INC.**
**Income Statement**
**For the Month Ended September 30, 2004**

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

**BEST CATERERS, INC.**
**Retained Earnings Statement**
**For the Month Ended September 30, 2004**

| | |
|---|---|
| Retained earnings, September 1 | $ 0 |
| Add: Net income | 2,750 |
| | 2,750 |
| Less: Dividends | 1,300 |
| Retained earnings, September 30 | $1,450 |

**BEST CATERERS, INC.**
**Balance Sheet**
**September 30, 2004**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $ 8,050 |
| Accounts receivable | | 1,400 |
| Supplies | | 1,600 |
| Equipment | | 7,000 |
| Total assets | | $18,050 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Accounts payable | | $ 1,600 |
| Stockholders' equity | | |
| Common stock | $15,000 | |
| Retained earnings | 1,450 | 16,450 |
| Total liabilities and stockholders' equity | | $18,050 |

**BEST CATERERS, INC.**
**Statement of Cash Flows**
**For the Month Ended September 30, 2004**

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

1

2

3

The beginning retained earnings amount is shown on the first line of the statement. Then, net income and dividends are identified. The retained earnings ending balance is the final amount on the statement. The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement.

## BALANCE SHEET

Best Caterers, Inc.'s balance sheet reports the assets, liabilities, and stockholders' equity at a specific date (September 30, 2004). The balance sheet is prepared from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1-8).

Observe that the assets are listed at the top, followed by liabilities and stockholders' equity. Total assets must equal total liabilities and stockholders' equity. In the Best Caterers illustration, only one liability, accounts payable, is reported on the balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is shown in Illustration 1-10.

**Illustration 1-10**

Presentation of liabilities

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

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

### ACCOUNTING IN ACTION *Business Insight*

Why do companies choose the particular year-ends that they do? Not every company uses December 31 as the accounting year-end. Many companies choose to end their accounting year when inventory or operations are at a low. This is advantageous because compiling accounting information requires much time and effort by managers, so they would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low. Some companies whose year-ends differ from December 31 are **Delta Air Lines**, June 30; **Walt Disney Productions**, September 30; **Kmart Corp.**, January 31; and **Dunkin Donuts, Inc.**, October 31.

## STATEMENT OF CASH FLOWS

The primary purpose of a statement of cash flows is to provide financial information about the cash receipts and cash payments of an enterprise for a specific period of time. **The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing transactions, (3) its financing transactions, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period.**

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

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

**HELPFUL HINT**
The cash at the end of the period reported in the statement of cash flows equals the cash reported in the balance sheet.

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

A statement of cash flows for Best Caterers, Inc. is provided in Illustration 1-9.

As shown in the statement, cash increased $8,050 during the period: Net cash flow provided from operating activities increased cash $1,350. Cash flow from investing transactions decreased cash $7,000. And cash flow from financing transactions increased cash $13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 6 will examine in detail how the statement is prepared.

## BEFORE YOU GO ON...

*REVIEW IT*

1. What are the income statement, retained earnings statement, balance sheet, and statement of cash flows?
2. How are the financial statements interrelated?

Image rights not available

**A Look Back** exercises refer to the chapter-opening Feature Story. These exercises help you analyze that real-world situation in terms of the accounting topic of the chapter.

## A LOOK BACK AT OUR FEATURE STORY

Refer back to the Feature Story about **Hilton** at the beginning of the chapter, and answer the following questions.

1. If you were interested in investing in **Hilton**, what would the balance sheet and income statement tell you?
2. Would you request audited financial statements? Explain.
3. Will the financial statements show the market value of the company? Explain.

*SOLUTION*

1. The balance sheet reports the assets, liabilities, and stockholders' equity of the company. The income statement presents the revenues and expenses and resulting net income (or net loss) for a specific period of time. The balance sheet is like a snapshot of the company's financial condition at a point in time. The income statement indicates the profitability of the company. Also, the sources of the company's revenues and its expenses are provided in the income statement.
2. You should request **audited** financial statements—statements that a CPA has examined and expressed an opinion as to the fairness of presentation. You should not make decisions without having audited financial statements.
3. The financial statements will not show the market value of the company. One important principle of accounting is the cost principle, which states that assets should be recorded at cost. Cost has an important advantage over other valuations: it is reliable.

THE NAVIGATOR

# DEMONSTRATION PROBLEM

Hospitality Legal Services, Inc., which provides contract services for caterers and their clients, was incorporated on July 1, 2004. During the first month of operations, the following transactions occurred.

1. Stockholders invested $10,000 in cash in exchange for shares of stock.
2. Paid $800 for July rent on office space.
3. Purchased office equipment on account, $3,000.
4. Provided legal services to clients for cash, $1,500 (use Service Revenue).
5. Borrowed $700 cash from a bank on a note payable.
6. Performed legal services for client on account, $2,000.
7. Paid monthly expenses: salaries $500; utilities $300; and telephone $100.

***Instructions***

**(a)** Prepare a tabular summary of the transactions.

**(b)** Prepare the income statement, retained earnings statement, and balance sheet at July 31 for Hospitality Legal Services, Inc.

**Demonstration Problems** are a final review of the chapter. The **Action Plan** gives tips about how to approach the problem, and the **Solution** demonstrates both the form and content of complete answers.

## ACTION PLAN

- Remember that assets must equal liabilities and stockholders' equity after each transaction.
- Investments and revenues increase stockholders' equity.
- Dividends and expenses decrease stockholders' equity.
- The income statement shows revenues and expenses for a period of time.
- The retained earnings statement shows the changes in retained earnings for a period of time.
- The balance sheet reports assets, liabilities, and stockholders' equity at a specific date.

## SOLUTION TO DEMONSTRATION PROBLEM

**(a)**

| | Assets | | | = | Liabilities | | + Stockholders' Equity | | |
|---|---|---|---|---|---|---|---|---|---|
| **Transaction** | **Cash** | **+ Accounts Receivable** | **+ Equipment** | **=** | **Notes Payable** | **+ Accounts Payable** | **+ Common Stock** | **+ Retained Earnings** | |
| (1) | +$10,000 | | | | | | +$10,000 | | |
| (2) | −800 | | | | | | | −$800 | Rent Expense |
| | 9,200 | | | = | | | 10,000 + | −800 | |
| (3) | | | +$3,000 | | | +$3,000 | | | |
| | 9,200 | | + 3,000 | = | | 3,000 + | 10,000 + | −800 | |
| (4) | +1,500 | | | | | | | +1,500 | Service Revenue |
| | 10,700 | | + 3,000 | = | | 3,000 + | 10,000 + | 700 | |
| (5) | +700 | | | | +$700 | | | | |
| | 11,400 | | + 3,000 | = | 700 + | 3,000 + | 10,000 + | 700 | |
| (6) | | +$2,000 | | | | | | +2,000 | Service Revenue |
| | +11,400 + | 2,000 | + 3,000 | = | 700 + | 3,000 + | 10,000 + | 2,700 | |
| (7) | −900 | | | | | | | −500 | Salaries Expense |
| | | | | | | | | −300 | Utilities Expense |
| | | | | | | | | −100 | Telephone Expense |
| | $10,500 + | $2,000 | + $3,000 | = | $700 + | $3,000 + | $10,000 + | $1,800 | |
| | $15,500 | | | | $15,500 | | | | |

**(b)**

**HOSPITALITY LEGAL SERVICES, INC.**
**Income Statement**
**For the Month Ended July 31, 2004**

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

**HOSPITALITY LEGAL SERVICES, INC.**
**Retained Earnings Statement**
**For the Month Ended July 31, 2004**

| | |
|---|---|
| Retained earnings, July 1 | $ –0– |
| Add: Net income | 1,800 |
| Retained earnings, July 31 | $1,800 |

**HOSPITALITY LEGAL SERVICES, INC.**
**Balance Sheet**
**July 31, 2004**

| | | |
|---|---|---|
| **Assets** | | |
| Cash | | $10,500 |
| Accounts receivable | | 2,000 |
| Equipment | | 3,000 |
| Total assets | | $15,500 |
| **Liabilities and Stockholders' Equity** | | |
| Liabilities | | |
| Notes payable | | $ 700 |
| Accounts payable | | 3,000 |
| Total liabilities | | 3,700 |
| Stockholders' equity | | |
| Common stock | $10,000 | |
| Retained earnings | 1,800 | 11,800 |
| Total liabilities and stockholders' equity | | $15,500 |

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

THE NAVIGATOR

## SUMMARY OF STUDY OBJECTIVES

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

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

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

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

**5.** ***Explain the meaning of the monetary unit assumption and the economic entity assumption.*** The monetary unit assumption requires that only transaction data capable of being expressed in terms of money be included in the accounting records. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owners and other economic entities.

**6.** ***State the basic accounting equation, and explain the meaning of assets, liabilities, and stockholders' equity.*** The basic accounting equation is:

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

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

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

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

THE NAVIGATOR

## GLOSSARY

**Accounting** The information system that identifies, records, and communicates the economic events of an organization to interested users (p. 2).

**Assets** Resources owned by a business (p. 11).

**Balance sheet** A financial statement that reports the assets, liabilities, and stockholders' equity at a specific date (p. 21).

**Basic accounting equation** Assets = Liabilities + Stockholders' Equity (p. 11).

**Bookkeeping** A part of accounting that involves only the recording of economic events (p. 6).

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

**Cost principle** An accounting principle that states that assets should be recorded at their cost (p. 9).

**Dividend** A distribution by a corporation to its stockholders on a pro rata (equal) basis (p. 12).

**Economic entity assumption** An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owners and all other economic entities (p. 10).

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

**Expenses** The cost of assets consumed or services used in the process of earning revenue (p. 12).

**Financial accounting** The field of accounting that provides economic and financial information for investors, creditors, and other external users (p. 6).

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

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

**Income statement** A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time (p. 21).

**Liabilities** Creditorship claims on total assets (p. 11).

**Managerial accounting** The field of accounting that provides economic and financial information for managers and other internal users (p. 6).

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

**Net income** The amount by which revenues exceed expenses (p. 12).

**Net loss** The amount by which expenses exceed revenues (p. 12).

**Partnership** An association of two or more persons to carry on as co-owners of a business for profit (p. 10).

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

**Retained earnings statement** A financial statement that summarizes the changes in retained earnings for a specific period of time (p. 21).

**Revenues** The gross increase in stockholders' equity resulting from business activities entered into for the purpose of earning income (p. 12).

**Securities and Exchange Commission (SEC)** A governmental agency that requires companies to file financial reports in accordance with generally accepted accounting principles (p. 9).

**Statement of cash flows** A financial statement that provides information about the cash inflows (receipts) and cash outflows (payments) of an entity for a specific period of time (p. 21).

**Stockholders' equity** The ownership claim on total assets of a corporation (p. 12).

**Transactions** The economic events of the enterprise that are recorded by accountants (p. 14).

## APPENDIX *The Accounting Profession*

What would you do if you join the accounting profession? You probably would work in one of three major fields—public accounting, private accounting, or not-for-profit accounting.

**STUDY OBJECTIVE 9**

Identify the three major fields of the accounting profession and potential accounting careers.

## PUBLIC ACCOUNTING

In **public accounting**, you would offer expert service to the general public in much the same way that a doctor serves patients and a lawyer serves clients. A major portion of public accounting practice involves **auditing**. In this area, a **certified public accountant** (CPA) examines the financial statements of companies and expresses an opinion as to the fairness of presentation. When the presentation is fair, users consider the statements to be **reliable**. For example, **Hilton** investors and creditors would demand audited financial statements before extending it financing.

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

A third area in public accounting is **management consulting**. It ranges from installing basic accounting systems to helping companies determine whether they should use the space shuttle for high-tech research and development projects.

## PRIVATE ACCOUNTING

Instead of working in public accounting, you might choose to be an employee of a business enterprise. In **private (or managerial) accounting**, you would be involved in one of the following activities.

1. **General accounting**—recording daily transactions and preparing financial statements and related information.
2. **Cost accounting**—determining the cost of producing specific products.
3. **Budgeting**—assisting management in quantifying goals concerning revenues, costs of goods sold, and operating expenses.
4. **Accounting information systems**—designing both manual and computerized data processing systems.
5. **Tax accounting**—preparing tax returns and engaging in tax planning for the company.
6. **Internal auditing**—reviewing the company's operations to determine compliance with management policies and evaluating the efficiency of operations.

You can see that within a specific company, private accountants perform as wide a variety of duties as the public accountant.

Illustration 1A-1 presents the general career paths in public and private accounting.

## NOT-FOR-PROFIT ACCOUNTING

Like businesses that exist to make a profit, not-for-profit organizations also need sound financial reporting and control. Donors to such organizations as the **Coca-Cola Foundation**, the **Conrad N. Hilton Foundation**, and the **Red Cross** want information about how well the organization has met its objectives and whether continued support is justified. Hospitals, colleges, and universities must make decisions about the allocation of funds. Local, state, and federal governmental units provide financial information to legislators, citizens, employees, and creditors. At the federal level, the largest employers of accountants are the **Internal Revenue Service**, the **General Accounting Office**, the **Federal Bureau of Investigation**, and the **Securities and Exchange Commission**.

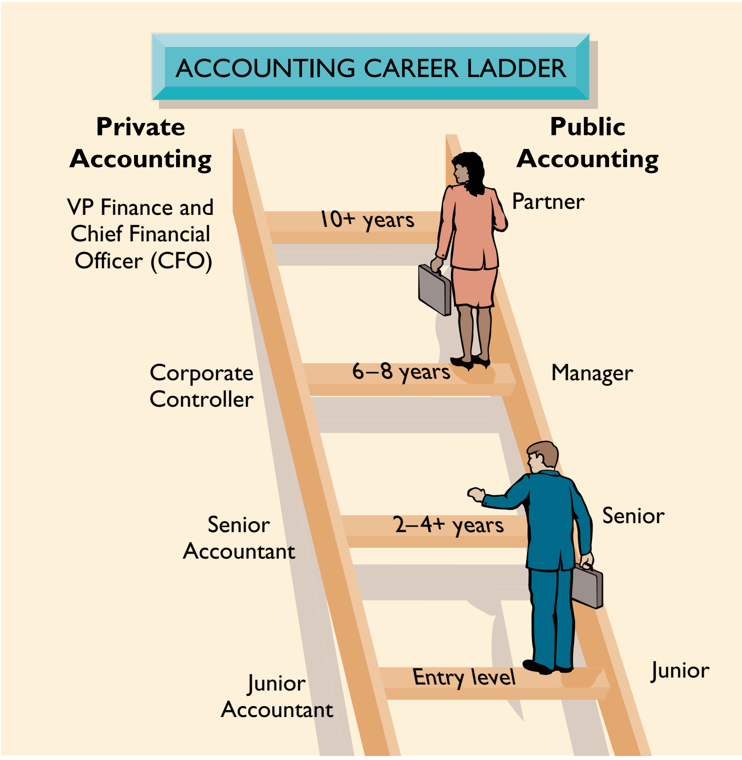



**Illustration 1A-1**

Career paths in public and private accounting

# SUMMARY OF STUDY OBJECTIVE FOR APPENDIX

**9. *Identify the three major fields of the accounting profession and potential accounting careers.*** The accounting profession comprises three major fields: public accounting, private accounting, and not-for-profit accounting. In public accounting one may pursue a career in auditing, taxation, or management consulting. In private or managerial accounting, one may pursue a career in cost accounting, budgeting, general accounting, accounting information systems, tax accounting, or internal auditing. In not-for-profit accounting one may pursue a career at hospitals, universities, and foundations, or in local, state, and federal governmental units.

# GLOSSARY FOR APPENDIX

**Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation (p. 28).

**Management consulting** An area of public accounting involving financial planning and control and the development of accounting and computer systems (p. 28).

**Private (or managerial) accounting** An area of accounting within a company that involves such activities as cost accounting, budgeting, and accounting information systems (p. 28).

**Public accounting** An area of accounting in which the accountant offers expert service to the general public (p. 28).

**Taxation** An area of public accounting involving tax advice, tax planning, and preparation of tax returns (p. 28).

# EXERCISES

*Use basic accounting equation.* (SO 6)

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

| | Assets | = | Liabilities | + | Stockholders' Equity |
|---|---|---|---|---|---|
| **(a)** | $90,000 | | $50,000 | | ? |
| **(b)** | ? | | $45,000 | | $85,000 |
| **(c)** | $97,000 | | ? | | $62,000 |

*Use basic accounting equation.*
(SO 6)

**1-2** Given the accounting equation, answer each of the following questions.

1. The liabilities of Leno Health Drinks are $90,000, and the stockholders' equity is $280,000. What is the amount of Leno's total assets?
2. The total assets of Letterman Pizza are $210,000, and its stockholders' equity is $90,000. What is the amount of its total liabilities?
3. The total assets of Conan Salads Co. are $900,000, and its liabilities are equal to one half of its total assets. What is the amount of Conan Salads' stockholders' equity?

*Use basic accounting equation.*
(SO 6)

**1-3** At the beginning of the year, Italian Pasta Company had total assets of $850,000 and total liabilities of $500,000. Answer the following questions.

1. If total assets increased $150,000 during the year and total liabilities decreased $80,000, what is the amount of stockholders' equity at the end of the year?
2. During the year, total liabilities increased $100,000 and stockholders' equity decreased $50,000. What is the amount of total assets at the end of the year?
3. If total assets decreased $90,000 and stockholders' equity increased $130,000 during the year, what is the amount of total liabilities at the end of the year?

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

**1-4** Presented below are three business transactions. On a sheet of paper, list the letters (a), (b), (c) with columns for assets, liabilities, and stockholders' equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and stockholders' equity.

**(a)** Purchased supplies on account.
**(b)** Received cash for providing a service.
**(c)** Expenses paid in cash.
**(d)** Invested cash in the business.
**(e)** Paid cash dividend.
**(f)** Received cash from a customer who had previously been billed for services provided.

*Classify various items.*
(SO 6, 7)

**1-5** Classify each of the following items as asset (A), liability (L), revenue (R), or expense (E).

| | |
|---|---|
| ____**(a)** Advertising expense | ____**(e)** Cash |
| ____**(b)** Commission revenue | ____**(f)** Rent revenue |
| ____**(c)** Insurance expense | ____**(g)** Utilities expense |
| ____**(d)** Office equipment | ____**(h)** Accounts payable |

*Classify accounts as assets, liabilities, or stockholders' equity.*
(SO 6)

**1-6** Pressing Cleaners has the following balance sheet items.

| | |
|---|---|
| Accounts payable | Accounts receivable |
| Cash | Notes payable |
| Cleaning equipment | Salaries payable |
| Cleaning supplies | Common stock |

***Instructions***

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

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

**1-7** Selected transactions for Green Acres Catering Company are listed below.

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

***Instructions***

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

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

**1-8** Blaskowski Foodservices entered into the following transactions during May 2004.

1. Purchased kitchen equipment for $22,000 from Wheeler Appliances on account.
2. Paid $5,000 cash for May rent on storage space.
3. Received $15,000 cash from customers for contracts billed in April.
4. Provided services to Bilder Construction Company for $10,000 cash.

5. Paid Southern States Power Co. $11,000 cash for energy usage in May.
6. Stockholders invested an additional $32,000 in the business.
7. Paid Wheeler Appliances for the terminals purchased in (1) above.
8. Incurred advertising expense for May of $2,000 on account.

***Instructions***

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

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

*Analyze transactions and compute net income.* (SO 6, 7)

**1-9** On April 1, Crossroads Travel Agency, Inc. was established. The following transactions were completed during the month.

1. Stockholders invested $20,000 cash, receiving common stock in exchange.
2. Paid $800 cash for April office rent.
3. Purchased office equipment for $2,500 cash.
4. Incurred $300 of advertising costs in the *Chicago Tribune,* on account.
5. Paid $750 cash for office supplies.
6. Earned $12,000 for services rendered: Cash of $3,000 is received from customers, and the balance of $9,000 is billed to customers on account.
7. Paid $500 cash dividend.
8. Paid *Chicago Tribune* amount due in transaction (4).
9. Paid employees' salaries $1,500.
10. Cash of $7,000 is received from customers who have previously been billed in transaction (6).

***Instructions***

**(a)** Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Office Equipment, Accounts Payable, Common Stock, and Retained Earnings.
**(b)** From an analysis of the Retained Earnings column, compute the net income or net loss for April.

*Analyze transactions and prepare income statement, balance sheet, and retained earnings statement.* (SO 6, 7, 8)

**1-10** Jennifer Lopez Cheesecake Corporation was formed on July 1, 2004. On July 31, the balance sheet showed Cash $5,000, Accounts Receivable $1,900, Supplies $500, Office Equipment $5,000, Accounts Payable $4,200, Common Stock $7,500, and Retained Earnings $700. During August the following transactions occurred.

1. Collected $1,600 of accounts receivable.
2. Paid $2,700 cash on accounts payable.
3. Earned revenues of $8,400, of which $3,000 is collected in cash and the balance is due in September.
4. Purchased additional office equipment for $1,000, paying $250 in cash and the balance on account.
5. Paid salaries $1,500, rent for August $1,100, and advertising expenses $350.
6. Paid dividends of $750.
7. Received $1,000 from Standard Federal Bank—money borrowed on a note payable.
8. Incurred utility expenses for month on account $300.

***Instructions***

**(a)** Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column heading should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + Common Stock + Retained Earnings.
**(b)** Prepare an income statement for August, a retained earnings statement for August, and a balance sheet at August 31.

## *FINANCIAL REPORTING PROBLEM: Hilton Hotels Corporation*

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**1-11** The actual financial statements of **Hilton Hotels**, as presented in the company's 2001 Annual Report, are contained in the Appendix (at the back of the textbook).

***Instructions***

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

**(a)** What were Hilton's total assets at December 31, 2001? At December 31, 2000?
**(b)** How much cash (and cash equivalents) did Hilton have on December 31, 2001?
**(c)** What amount of accounts payable did Hilton report on December 31, 2001? On December 31, 2000?
**(d)** What was Hilton's total revenue in 2000? In 2001?
**(e)** What is the amount of the change in Hilton's net income from 2000 to 2001?

## *EXPLORING THE WEB*

**1-12** This exercise will familiarize you with skill requirements, job descriptions, and salaries for accounting careers.

***Address:*** **www.careers-in-accounting.com**

***Instructions***

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

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

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### *Answer to Hilton Review It Question 4, p. 13*

Hilton's accounting equation is:

| Assets | | Liabilities | | Stockholders' Equity |
|---|---|---|---|---|
| $8,785,000 | = | $7,002,000 | + | $1,783,000 |

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