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Accounting in Action

The **Chapter Preview** describes the purpose of the chapter and highlights major topics.

Chapter Preview

The following Feature Story about **Columbia Sportswear Company** highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information. The purpose of this chapter is to show you that accounting is the system used to provide useful financial information.

The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.

Feature Story

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, “If I’m not going to be an accountant, why do I need

to know accounting?” Well, consider this quote from Harold Geneen, a former chairman of **IT&T**: “To be good at your business, you have to know the numbers—cold.” In business, accounting and financial statements are the means for communicating the numbers. If you don’t know how to read financial statements, you can’t really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of **Columbia Sportswear Company**, headquartered in Portland, Oregon. Gert Boyle's family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat Company. In 1971, Gert's husband, who was then running the company, died suddenly of a heart attack. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of \$1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail.

Columbia doesn't just focus on financial success. Several of its factories have participated in a project to increase

health awareness of female factory workers in developing countries. Columbia is also a founding member of the Sustainable Apparel Coalition, which strives to reduce the environmental and social impact of the apparel industry. In addition, the company monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address such issues as forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

Employers such as Columbia Sportswear generally assume that managers in all areas of the company are "financially literate." To help prepare you for that, this text will help you learn how to read and prepare financial statements, and how to use key tools to evaluate financial results using basic data analytics.

Chapter Outline

The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.

LEARNING OBJECTIVES

REVIEW

PRACTICE

<p>LO 1 Identify the activities and users associated with accounting.</p>	<ul style="list-style-type: none"> • Three activities • Who uses accounting data 	<p>DO IT! 1 Basic Concepts</p>
<p>LO 2 Explain the building blocks of accounting: ethics, principles, and assumptions.</p>	<ul style="list-style-type: none"> • Ethics • GAAP • Measurement principles • Assumptions 	<p>DO IT! 2 Building Blocks of Accounting</p>
<p>LO 3 State the accounting equation, and define its components.</p>	<ul style="list-style-type: none"> • Assets • Liabilities • Owner's equity 	<p>DO IT! 3 Owner's Equity Effects</p>
<p>LO 4 Analyze the effects of business transactions on the accounting equation.</p>	<ul style="list-style-type: none"> • Accounting transactions • Transaction analysis • Summary of transactions 	<p>DO IT! 4 Tabular Analysis</p>
<p>LO 5 Describe the four financial statements and how they are prepared.</p>	<ul style="list-style-type: none"> • Income statement • Owner's equity statement • Balance sheet • Statement of cash flows • Financial statements: order of preparation 	<p>DO IT! 5 Financial Statement Items</p>

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.

Visit WileyPLUS for additional tutorials and practice opportunities.

Accounting Activities and Users

LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by **Nike** founder Phil Knight, **Home Depot** co-founder Arthur Blank, former acting director of the **Federal Bureau of Investigation (FBI)** Thomas Pickard, and numerous members of Congress? Accounting.¹ Why did these people choose accounting?

- They wanted to understand what was happening financially to their organizations.
- Accounting is the financial information system that provides these insights.
- In short, to understand your organization, you have to know the numbers.

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

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

Three Activities

As a starting point to the accounting process, a company **identifies the economic events relevant to its business**. Examples of economic events are the sale of snack chips by **PepsiCo**, the provision of telephone services by **AT&T**, and the payment of wages by **Facebook**.

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

Finally, PepsiCo **communicates** the collected information to interested users by means of accounting reports.

- We refer to the communication process as financial reporting.
- The most common accounting reports are called financial statements.

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

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information.

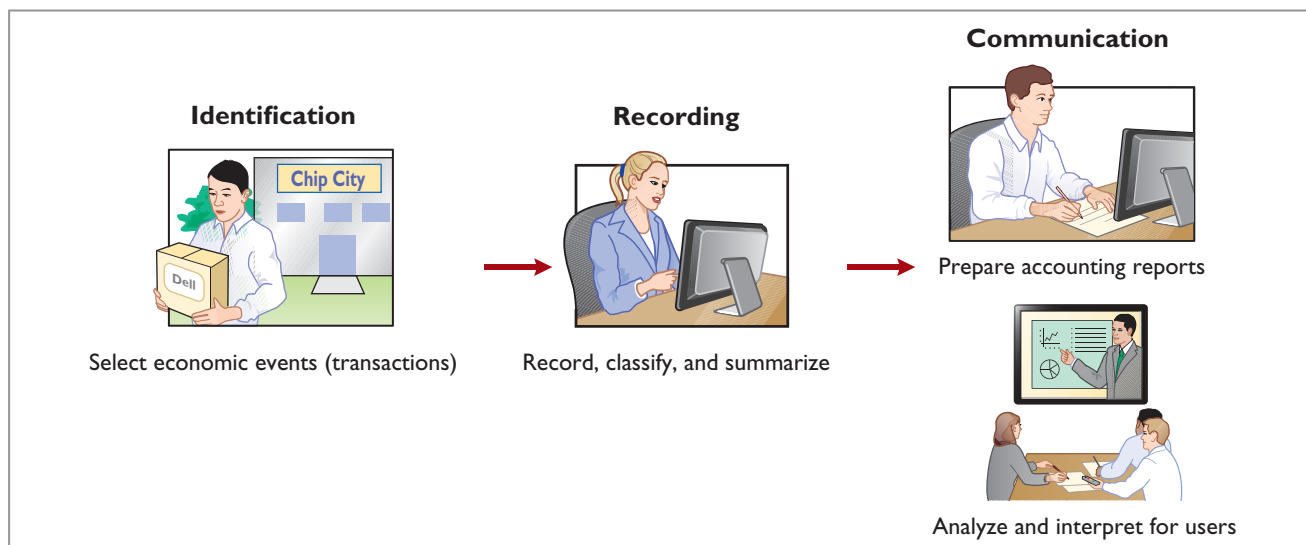
- **Analysis** involves use of ratios, percentages, and data visualization (graphs and charts) to highlight significant financial trends and relationships.
- **Interpretation** involves explaining the uses, meaning, and limitations of reported data.

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

Appendices A–E show the financial statements of **Apple Inc.**, **PepsiCo, Inc.**, **The Coca-Cola Company**, **Amazon.com, Inc.**, and **Walmart Inc.**, respectively. (In addition, in the *A Look at IFRS* section at the end of each chapter, the French company **LVMH—Louis Vuitton** is analyzed.) We refer to these statements at various places throughout the text. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1.1 summarizes the activities of the accounting process.

ILLUSTRATION 1.1 The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function.

- **Bookkeeping** usually involves only the recording of economic events.
- It is just one part of the accounting process.

In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**²

Who Uses Accounting Data

HELPFUL HINT

Throughout this text, we will highlight examples where accounting information is used to support business decisions using *data analytics*.

Accounting software systems collect vast amounts of data about the economic events experienced by a company and about the parties with whom the company engages, such as suppliers and customers. Business decision-makers take advantage of this wealth of data by using **data analytics** to make more informed business decisions.

- Data analytics involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see **Helpful Hint**).

Helpful Hints further clarify concepts being discussed.

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

Insight boxes provide examples of business situations from various perspectives—ethics, investor, international, corporate social responsibility, and data analytics. Guideline answers to the critical thinking questions as well as questions are available near the end of the chapter.

Data Analytics Insight Netflix



Ronnie Overgoor/
UnSplash

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called “big data.” And **Netflix**, the world’s leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend \$8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions,

such as filming locations and production schedules, Netflix can more precisely estimate costs for future productions. Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Ritwik Kumar et. al., “Data Science and the Art of Producing Entertainment at Netflix,” *The Netflix Tech Blog* (March 26, 2018).

How can “big data” improve decision-making? (Answer is available near the end of the chapter.)





Users of accounting information can be divided broadly into two groups: internal users and external users.

Internal Users

Internal users of accounting information are the managers who plan, organize, and run a business. Internal users include **marketing managers, production supervisors, finance directors, and company officers**. In running a business, internal users must answer many important questions, as shown in **Illustration 1.2**.

ILLUSTRATION 1.2 Questions that internal users ask

Questions Asked by Internal Users

 <p>Finance</p> <p>Is cash sufficient to pay dividends to Microsoft stockholders?</p>	 <p>Marketing</p> <p>What price should Apple charge for an iPhone to maximize the company's net income?</p>	 <p>Human Resources</p> <p>Can General Motors afford to give its employees pay raises this year?</p>	 <p>Snacks Beverages</p> <p>Management</p> <p>Which PepsiCo product line is the most profitable? Should any product lines be eliminated?</p>
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To answer these and other questions, internal users need detailed information on a timely basis.

- **Managerial accounting** provides internal reports to help users make decisions about their companies.
- Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

External Users

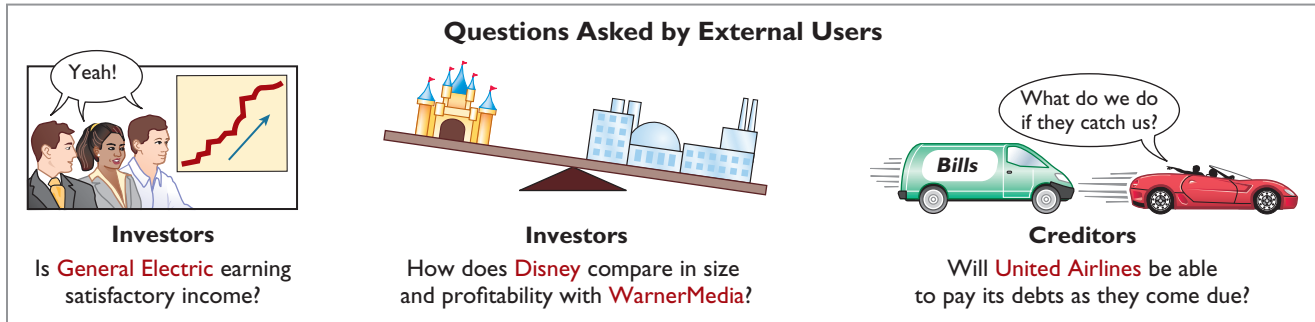
External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.

- **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company.

- **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money.

Illustration 1.3 shows some questions that investors and creditors may ask.

ILLUSTRATION 1.3 Questions that external users ask



Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably.

- **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with tax laws.
- **Customers** are interested in whether a company like **Tesla, Inc.** will continue to honor product warranties and support its product lines.
- **Labor unions**, such as the **Major League Baseball Players Association**, want to know whether the owners have the ability to pay increased wages and benefits.
- **Regulatory agencies**, such as the Securities and Exchange Commission or the Federal Trade Commission, want to know whether the company is operating within prescribed rules.

ACTION PLAN

- Review the basic concepts discussed.
- Develop an understanding of the key terms used.

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

DO IT! 1 | Basic Concepts

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

Solution

1. True. 2. False. Bookkeeping involves only the recording step. 3. False. Accountants analyze and interpret information in reports as part of the communication step. 4. False. The two most common types of external users are investors and creditors. 5. True.

Related exercise material: **DO IT! 1.1, E1.1, and E1.2.**

The Building Blocks of Accounting

LEARNING OBJECTIVE 2

Explain the building blocks of accounting: ethics, principles, and assumptions.

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building.

- Similarly, an accountant follows certain standards in reporting financial information.
- These standards are based on specific principles and assumptions.

For these standards to work, however, a fundamental business concept must be present—ethical behavior.

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the stock market if they think share prices are rigged. At one time, the financial press was full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG**. As more scandals came to light, a mistrust of financial reporting in general seemed to be developing.

One article in the *Wall Street Journal* noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling."

- Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility.
- There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals.

- As a result of SOX, top management must now certify the accuracy of financial information.
- In addition, penalties for fraudulent financial activity are much more severe.
- Also, SOX increased the independence requirements of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors (see **Ethics Note**).

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

1. A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *People, Planet, and Profit Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

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

ETHICS NOTE

Circus-founder P.T. Barnum is alleged to have said, "Trust everyone, but cut the deck." What Sarbanes-Oxley does is to provide measures (like cutting the deck of playing cards) that help reduce incidents of fraud.

When analyzing these various 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 and situations



1. Recognize an ethical situation and the ethical issues involved.

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

2. Identify and analyze the principal elements in the situation.

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

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.

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

Ethics Insight Dewey & LeBoeuf LLP



Alliance Images/
Shutterstock.com

I Felt the Pressure—Would You?

“I felt the pressure.” That’s what some of the employees of the now-defunct law firm of **Dewey & LeBoeuf LLP** indicated when they helped to overstate revenue and use accounting tricks to hide losses and cover up cash shortages. These employees worked for the former finance director and former chief financial officer (CFO) of the firm. Here are some of their comments:

- “I was instructed by the CFO to create invoices, knowing they would not be sent to clients. When I created these invoices, I knew that it was inappropriate.”
- “I intentionally gave the auditors incorrect information in the course of the audit.”

What happened here is that a small group of lower-level employees over a period of years carried out the instructions of their bosses. Their bosses, however, seemed to have no concern about unethical practices as evidenced by various e-mails with one another in which they referred to their financial manipulations as accounting tricks, cooking the books, and fake income.

Sources: Ashby Jones, “Guilty Pleas of Dewey Staff Detail the Alleged Fraud,” *Wall Street Journal* (March 28, 2014); and Sara Randazzo, “Dewey CFO Escapes Jail Time in Fraud Case Sentencing,” *Wall Street Journal* (October 10, 2017).

Why did these employees lie, and what do you believe should be their penalty for these lies? (Answer is available near the end of the chapter.)

International Note

Over 160 countries use international standards (called IFRS). For example, all companies in the European Union follow IFRS. The differences between U.S. and international standards are not generally significant.

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

Generally Accepted Accounting Principles

The accounting profession has developed standards that are generally accepted and universally practiced.

- This common set of standards is called **generally accepted accounting principles (GAAP)**.
- These standards indicate how to report economic events.

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow.

Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)** (see **International Note**).

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, the two standard-setting bodies made efforts to reduce the differences between U.S. GAAP and IFRS.

However, it seems likely that there will continue to be two sets of financial reporting standards in the world for the foreseeable future due to the FASB and the IASB taking different approaches to various financial reporting issues. We highlight any major differences between GAAP and IFRS in *International Notes* as part of the text discussion as well as provide a more in-depth analysis in the *A Look at IFRS* section at the end of each chapter.

International Insight



Toru Hanai/Pool/Getty Images

The Korean Discount

If you think that accounting standards don't matter, consider events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards.

This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, and Japan, have also decided either to adopt international standards or to create standards that are based on the international standards.

Source: Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth? (Answer is available near the end of the chapter.)

Measurement Principles

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation (see **Helpful Hint**).

- **Relevance** means that financial information is capable of making a difference in a decision.
- **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

HELPFUL HINT

Relevance and faithful representation are two primary qualities that make accounting information useful for decision-making.

Historical Cost Principle

The **historical cost principle** (or cost principle) dictates that companies record assets at their cost.

- Assets are resources a company owns.
- Companies use the historical cost principle to value assets not only at the time the asset is purchased but also over the time the asset is held.

For example, if **Best Buy** purchases land for \$360,000, the company initially reports it in its accounting records at \$360,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to \$400,000? Under the historical cost principle, it continues to report the land at \$360,000.

Fair Value Principle

The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability).

- Liabilities are creditor claims against assets.
- Fair value information may be more useful than historical cost for certain types of assets and liabilities.
- For example, certain investment securities are reported at fair value because market price information is usually readily available for these types of assets.

In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

Assumptions

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

Monetary Unit Assumption

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms.

- This assumption enables accounting to quantify (measure) economic events.
- The monetary unit assumption is vital to applying the historical cost principle.

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

Economic Entity Assumption

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 (see **Ethics Note**).

- An economic entity can be any organization or unit in society.
- It may be a company (such as **Crocs, Inc.**), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist).

To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of her business. Similarly, **J. Crew** and **Gap Inc.** are segregated into separate economic entities for accounting purposes.

Proprietorship A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships.

- Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship.
- The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.

ETHICS NOTE

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

There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership A business owned by two or more persons associated as partners is a **partnership**. In most respects, a partnership is like a proprietorship except that more than one owner is involved.

- Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner.
- Each partner generally has unlimited personal liability for the debts of the partnership.
- Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.

Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and certified public accountants).

Corporation A business organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock is a **corporation**.

- The holders of the shares (stockholders) enjoy limited liability; that is, they are not personally liable for the debts of the corporate entity.
- Stockholders may transfer all or part of their ownership shares to other investors at any time (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation.
- Because ownership can be transferred without dissolving the corporation, the corporation enjoys an unlimited life.

Although the combined number of proprietorships and partnerships in the United States is more than five times the number of corporations, the revenue produced by corporations is eight times greater. Most of the largest companies in the United States—for example, **ExxonMobil**, **Ford**, **Walmart Inc.**, **Citigroup**, and **Apple**—are corporations.

Accounting Across the Organization



blublaf/E+/Getty Images

Spinning the Career Wheel

How will the study of accounting help you? A working knowledge of accounting is desirable for virtually every field of business. Some examples of how accounting is used in business careers include:

General management: Managers at **Ford Motors**, **Massachusetts General Hospital**, **California State University–Fullerton**, a **McDonald's** franchise, and

a **Trek** bike shop all need to understand accounting data in order to make wise business decisions.

Marketing: Marketing specialists at **Procter & Gamble** must be sensitive to costs and benefits, which accounting helps them quantify and understand. Making a sale is meaningless unless it is a profitable sale.

Finance: Do you want to be a banker for **Citicorp**, an investment analyst for **Goldman Sachs**, or a stockbroker for **Merrill**

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

Hospitality: Have you considered being an event planner or a general manager for a major hotel like **Marriott**? Leaders in these roles rely on the ability to interpret financial data such as sales from food and beverage, guest rooms, and events as indicators for future forecasting and critical operational decision-making.

How might accounting help you? (Answer is available near the end of the chapter.)

ACTION PLAN

- Review the discussion of ethics and financial reporting standards.
- Develop an understanding of the key terms used.

DO IT! 2 | Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. Congress passed the Sarbanes-Oxley Act to reduce unethical behavior and decrease the likelihood of future corporate scandals.
2. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board (FASB).
3. The historical cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if its fair value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

Solution

1. True. 2. True. 3. False. The historical cost principle dictates that companies record assets at their cost. Under the historical cost principle, the company must also use cost in later periods. 4. False. Faithful representation, not relevance, means that financial information matches what really happened; the information is factual. 5. True.

Related exercise material: **DO IT! 1.2, E1.3, and E1.4.**

The Accounting Equation

LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **Google** has total assets of approximately \$275.9 billion. Liabilities and owner's equity are the rights or claims against these resources. Thus, Google has \$275.9 billion of claims against its \$275.9 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **owner's equity**. Google has liabilities of \$74.5 billion and owner's equity of \$201.4 billion.

We can express the relationship of assets, liabilities, and owner's equity as an equation, as shown in **Illustration 1.5**.

ILLUSTRATION 1.5 The basic accounting equation

Assets	=	Liabilities	+	Owner's Equity
Resources owned by the business		Creditor claim against total assets		Owner's claim against total assets

This relationship is the **basic accounting equation**.

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

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

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

Assets

As noted above, **assets** are resources a business owns.

- The business uses its assets in carrying out such activities as production and sales.
- The common characteristic possessed by all assets is the capacity to provide future services or benefits.
- In a business, that service potential or future economic benefit eventually results in cash inflows (receipts).

For example, consider Campus Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza include tables, chairs, jukebox, cash register, oven, tableware, and, of course, cash.

Liabilities

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

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

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

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

Owner's Equity

The ownership claim on total assets is **owner's equity** (see **Helpful Hint**). It is equal to total assets minus total liabilities. Here is why:

- The assets of a business are claimed by either creditors or owners.
- To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets.
- The remainder is the owner's claim on the assets—the owner's equity.

Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

For example, say you purchase a car, an asset, that has a sales price of \$15,000. You pay \$5,000 cash and borrow the remainder, \$10,000, from a bank. You, the owner, have claim to the \$5,000 you paid, and the bank, the creditor, has claim to the \$10,000 that you borrowed from it. As **Illustration 1.6** shows, your owner's equity (\$5,000) is equal to your asset (\$15,000 car) minus your liability (bank's claim of \$10,000).

HELPFUL HINT

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

ILLUSTRATION 1.6
Determining owner's equity

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Car		Bank's Claim		Your Claim
\$15,000	=	\$10,000	+	\$5,000



Increases in Owner's Equity

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

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

HELPFUL HINT

The effect of revenues is positive—an increase in owner's equity coupled with an increase in assets or a decrease in liabilities.

Revenues **Revenues** are the **increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business** (see **Helpful Hint**). Revenues usually result in an increase in an asset. They may arise from different sources and are called different 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.

Decreases in Owner's Equity

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

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

HELPFUL HINT

The effect of expenses is negative—a decrease in owner's equity coupled with a decrease in assets or an increase in liabilities.

Expenses **Expenses** are the cost of assets consumed or services used in the process of generating revenue (see **Helpful Hint**). They are **decreases in owner's equity that result from operating the business**. Like revenues, expenses take many forms and are titled differently depending on the type of asset consumed or service used. For example, Campus Pizza recognizes the following expenses: cost of ingredients (meat, flour, cheese, tomato paste, mushrooms, etc.); cost of beverages; salaries and wages expense; utilities expense (electric, gas, and water expense); delivery expense (gasoline, repairs, licenses, etc.); supplies expense (napkins, detergents, aprons, etc.); rent expense; interest expense; and property tax expense.

Let's summarize the increases and decreases to owner's equity.

- Owner's equity is increased by an owner's investments and by revenues from business operations.
- Owner's equity is decreased by an owner's withdrawals of assets and by expenses.

Illustration 1.7 expands the basic accounting equation by showing the items that comprise owner's equity. This format is referred to as the **expanded accounting equation**.

ILLUSTRATION 1.7 Expanded accounting equation

Basic Equation	Assets	=	Liabilities	+	Owner's Equity						
Expanded Equation	Assets	=	Liabilities	+	Owner's Capital	-	Owner's Drawings	+	Revenues	-	Expenses
Examples	<ul style="list-style-type: none"> • Cash • Accounts Receivable • Supplies • Equipment 		<ul style="list-style-type: none"> • Accounts Payable 		<ul style="list-style-type: none"> • Owner's Capital 		<ul style="list-style-type: none"> • Owner's Drawings 		<ul style="list-style-type: none"> • Service Revenue 		<ul style="list-style-type: none"> • Advertising Expense • Salaries and Wages Expense • Rent Expense • Utilities Expense

DO IT! 3 | Owner's Equity Effects

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

1. Rent Expense.
2. Service Revenue.
3. Drawings.
4. Salaries and Wages Expense.

Solution

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

Related exercise material: BE1.1, BE1.2, BE1.3, BE1.4, BE1.5, BE1.6, DO IT! 1.3, and E1.5.

ACTION PLAN

- Understand the sources of revenue.
- Understand what causes expenses.
- Review the rules for changes in owner's equity.
- Recognize that drawings are withdrawals of cash or other assets from the business for personal use.

Analyzing Business Transactions

LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.



The system of collecting and processing transaction data and communicating financial information to decision-makers is known as the **accounting information system**. Factors that shape an accounting information system include the nature of the company's business, the types of transactions, the size of the company, the volume of data, and the information demands of management and others.

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems.

- These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements.
- Many companies have upgraded their accounting information systems in response to the requirements of Sarbanes-Oxley.
- In addition, companies are utilizing new technologies such as cloud-based storage, which permits employees to access records from different locations, and data automation and analytics tools, which help companies interpret large volumes of data to support enhanced decision-making and automate routine processes.

In this text, in order to emphasize the underlying concepts and principles, we focus on a manual accounting system. The accounting concepts and principles do not change whether a system is computerized or manual.

This **accounting cycle graphic** illustrates the steps companies follow each period to record transactions and eventually prepare financial statements.

Accounting information systems rely on a process referred to as **the accounting cycle**. As you can see from the graphic at the beginning of this section, the accounting cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. We explain each of the steps, starting in this chapter and continuing in Chapters 2–4.

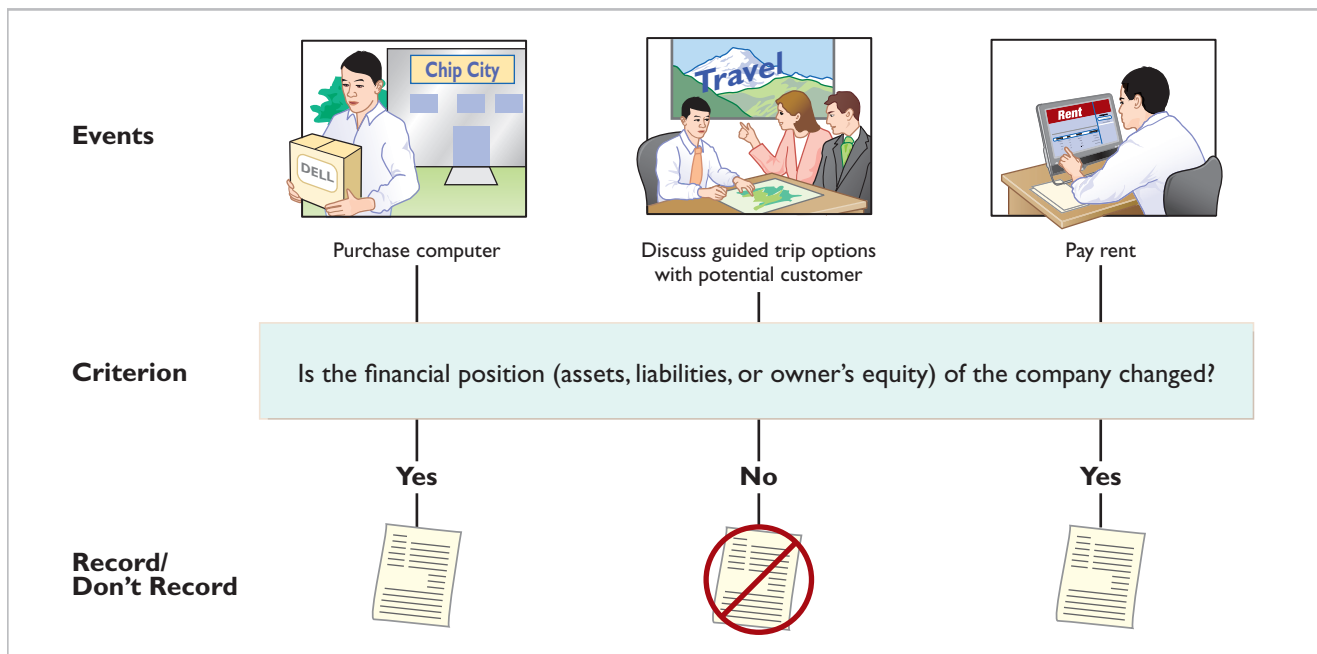
Accounting Transactions

Transactions (business transactions) are a business's economic events recorded by accountants. Transactions may be external or internal.

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

Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. **Illustration 1.8** demonstrates the transaction identification process.

ILLUSTRATION 1.8 Transaction identification process



Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding:

- Decrease in another asset, *or*
- Increase in a specific liability, *or*
- Increase in owner's equity.

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

Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte, a smartphone app development company (see **Helpful Hint**). Softbyte is the creation of Ray Neal, an entrepreneur who wants to create focused apps that inspire and engage users of all ages. Ray was encouraged to start his own business after the success of “FoodAlert,” a customizable app he developed that tracks the daily location of local food trucks. The following business transactions occur during Softbyte’s first month of operations (**Helpful Hint**).

Transaction 1. Investment of Cash by Owner Ray Neal starts a smartphone app development company which he names Softbyte. On September 1, 2022, he invests \$15,000 cash in the business. This transaction results in an equal increase in assets and owner’s equity.

Basic
Analysis

The asset Cash increases \$15,000, and owner’s equity (specifically, Owner’s Capital) increases \$15,000.

Equation
Analysis

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner’s Equity</u>	
	Cash	=			Owner’s Capital	
(1)	+\$15,000	=			+\$15,000	Initial Investment

HELPFUL HINT

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

HELPFUL HINT

Notice that for each transaction, the equality of the accounting equation has been maintained—total assets will still equal total liabilities plus owner’s equity.

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

Transaction 2. Purchase of Equipment for Cash Softbyte purchases computer equipment for \$7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.

Basic
Analysis

The asset Cash decreases \$7,000, and the asset Equipment increases \$7,000.

Equation
Analysis

	<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Owner’s Equity</u>	
	Cash	+ Equipment	=			Owner’s Capital	
	\$15,000		=			\$15,000	
(2)	-7,000	+7,000	=			\$15,000	
	\$ 8,000	+ \$7,000	=			\$15,000	
	\$15,000						

Observe that total assets are still \$15,000. Owner’s equity also remains at \$15,000, the amount of Ray Neal’s original investment.

Transaction 3. Purchase of Supplies on Credit Softbyte purchases headsets (and other computer accessories expected to last several months) for \$1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October. This transaction is a **purchase on account** (a credit purchase). Assets increase because of the expected future benefits of using the headsets and computer accessories, and liabilities increase by the amount due Mobile Solutions (see **Helpful Hint**).

HELPFUL HINT

“On account” or “on credit” means that cash will be paid at a later date.

Basic Analysis The asset Supplies increases \$1,600, and the liability Accounts Payable increases \$1,600.

Equation Analysis		Assets			=	Liabilities		+	Owner's Equity	
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital
		\$8,000				\$7,000				\$15,000
	(3)	\$8,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000
	\$16,600				\$16,600					

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

Transaction 4. Services Performed for Cash Softbyte receives \$1,200 cash from customers for app development services it has performed. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases owner's equity**.

Basic Analysis The asset Cash increases \$1,200, and owner's equity increases \$1,200 due to Service Revenue.

Equation Analysis		Assets			=	Liabilities		+	Owner's Equity			
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital	+	Revenues
		\$8,000		\$1,600		\$7,000		\$1,600		\$15,000		
	(4)	+\$1,200		\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	+\$1,200
	\$17,800				\$17,800							

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

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

Transaction 5. Purchase of Advertising on Credit Softbyte receives a bill for \$250 from the *Daily News* for advertising on its online website but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in owner's equity. Recall that **expenses decrease owner's equity**.

Basic Analysis The liability Accounts Payable increases \$250, and owner's equity decreases \$250 due to Advertising Expense.

Equation Analysis		Assets			=	Liabilities		+	Owner's Equity					
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital	+	Revenues	-	Expenses
		\$9,200		\$1,600		\$7,000		\$1,600		\$15,000		\$1,200		
	(5)	\$9,200	+	\$1,600	+	\$7,000	=	+\$250	+	\$15,000	+	\$1,200	-	-\$250
	\$17,800				\$17,800									

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

HELPFUL HINT

"Incurred" is a term used by accountants to indicate that an expense has occurred and needs to be recognized (whether paid in cash or not).

Transaction 6. Services Performed for Cash and Credit Softbyte performs \$3,500 of app development services for customers. The company receives cash of \$1,500 from customers, and it bills the balance of \$2,000 on account (see **Helpful Hint**). This transaction results in an equal increase in assets and owner's equity. Recall that **revenues increase owner's equity**.

HELPFUL HINT

Revenues are recorded for the total amount earned, even if all of the cash has not yet been received.

Basic
Analysis

Three specific items are affected: The asset Cash increases \$1,500, the asset Accounts Receivable increases \$2,000, and owner's equity increases \$3,500 due to Service Revenue.

Equation
Analysis

Assets	=	Liabilities	+	Owner's Equity
Cash + Accounts Receivable + Supplies + Equipment	=	Accounts Payable	+	Owner's Capital + Revenues - Expenses
\$ 9,200	=	\$1,850	+	\$15,000
+ \$1,500	=	+ \$1,850	+	+ \$15,000
+ \$2,000	=	+ \$15,000	+	+ \$4,700
+ \$1,600	=	+ \$4,700	-	- \$250
+ \$7,000	=	- \$250	-	-
\$21,300	=	\$1,850	+	\$21,300

+\$3,500 Ser. Rev.

Softbyte recognizes \$3,500 in revenues when it performs the service. In exchange for this service, it received \$1,500 in Cash and Accounts Receivable of \$2,000. This Accounts Receivable represents customers' promises to pay \$2,000 to Softbyte in the future (see **Helpful Hint**). When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable (see Transaction 9).

HELPFUL HINT

Accounts receivable is recorded when a company will receive cash from a customer in the future. Accounts payable is recorded when a company will pay cash to a vendor in the future (that is, the company is the customer).

Transaction 7. Payment of Expenses Softbyte pays the following expenses in cash for September: office rent \$600, salaries and wages of employees \$900, and utilities \$200. These payments result in an equal decrease in assets and owner's equity. Recall the **expenses decrease owner's equity**.

Basic
Analysis

The asset Cash decreases \$1,700, and owner's equity decreases \$1,700 due to the following expenses: Rent Expense, Salaries and Wages Expense, and Utilities Expense.

Equation
Analysis

Assets	=	Liabilities	+	Owner's Equity
Cash + Accounts Receivable + Supplies + Equipment	=	Accounts Payable	+	Owner's Capital + Revenues - Expenses
\$ 10,700	=	\$1,850	+	\$15,000
+ \$2,000	=	+ \$1,850	+	+ \$15,000
+ \$1,600	=	+ \$15,000	+	+ \$4,700
+ \$7,000	=	+ \$4,700	-	- \$250
\$ 9,000	=	\$1,850	+	\$19,950
- \$1,700	=	+ \$15,000	+	- \$600
+ \$2,000	=	+ \$4,700	-	- \$900
+ \$1,600	=	- \$1,950	-	- \$200
+ \$7,000	=	-	-	-
\$19,600	=	\$19,600	=	\$19,600

-600 Rent Exp.
-900 Sal./Wages Exp.
-200 Utilities Exp.

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 Softbyte pays its \$250 *Daily News* bill in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable and a decrease in owner's equity.

Basic Analysis This cash payment "on account" decreases the asset Cash by \$250 and also decreases the liability Accounts Payable by \$250.

Equation Analysis

Assets				=	Liabilities		+	Owner's Equity			
Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+ Owner's Capital	+ Revenues	- Expenses			
\$9,000	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,850	+ \$15,000	+ \$4,700	- \$1,950			
-250					-250						
\$8,750	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,600	+ \$15,000	+ \$4,700	- \$1,950			
\$19,350					\$19,350						

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

Transaction 9. Receipt of Cash on Account Softbyte receives \$600 in cash from customers who had been billed for services (in Transaction 6). Transaction 9 does not change total assets, but it changes the composition of those assets.

Basic Analysis The asset Cash increases \$600, and the asset Accounts Receivable decreases \$600.

Equation Analysis

Assets				=	Liabilities		+	Owner's Equity			
Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+ Owner's Capital	+ Revenues	- Expenses			
\$8,750	+ \$2,000	+ \$1,600	+ \$7,000	=	\$1,600	+ \$15,000	+ \$4,700	- \$1,950			
+600	-600										
\$9,350	+ \$1,400	+ \$1,600	+ \$7,000	=	\$1,600	+ \$15,000	+ \$4,700	- \$1,950			
\$19,350					\$19,350						

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

Transaction 10. Withdrawal of Cash by Owner Ray Neal withdraws \$1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity. Recall that **drawings decrease owner's equity**.

Basic Analysis The asset Cash decreases \$1,300, and owner's equity decreases \$1,300 due to owner's withdrawal (Owner's Drawings).

Equation Analysis

Assets				=	Liabilities		+	Owner's Equity			
Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+ Owner's Capital	- Owner's Drawings	+ Revenues	- Expenses		
\$9,350	+ \$1,400	+ \$1,600	+ \$7,000	=	\$1,600	+ \$15,000		+ \$4,700	- \$1,950		
-1,300							-1,300			Drawings	
\$8,050	+ \$1,400	+ \$1,600	+ \$7,000	=	\$1,600	+ \$15,000	- \$1,300	+ \$4,700	- \$1,950		
\$18,050					\$18,050						

Observe that the effect of a cash withdrawal by the owner is the opposite of the effect of an investment by the owner.

- **Owner's drawings are not expenses.**
- Expenses are incurred for the purpose of earning revenue.
- Drawings do not generate revenue. They are a **disinvestment**.

Like owner's investment, the company excludes owner's drawings in determining net income.

Summary of Transactions

Illustration 1.9 summarizes the September transactions of Softbyte to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction.

Illustration 1.9 demonstrates some significant facts:

1. Each transaction is analyzed in terms of its effect on:
 - a. The three components of the basic accounting equation (assets, liabilities, and owner's equity).
 - b. Specific types (kinds) of items within each component (such as the asset Cash).
2. The two sides of the equation must always be equal.
3. The Owner's Capital, Owner's Drawings, Revenues, and Expenses columns indicate the causes of each change in the owner's claim on assets.

ILLUSTRATION 1.9 Tabular summary of Softbyte transactions

Transaction	Assets				=	Liabilities	+	Owner's Equity											
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=		Accounts Payable	+	Owner's Capital	-	Owner's Drawings	+	Revenues
(1)	+\$15,000						+	\$15,000											Initial invest.
(2)	-7,000																		
(3)																			
(4)	+1,200																		Service Revenue
(5)																			Adver. Expense
(6)	+1,500																		Service Revenue
(7)	-1,700																		Rent Expense
																			Sal./Wages Exp.
																			Utilities Expense
(8)	-250																		
(9)	+600																		
(10)	-1,300																		Drawings
	<u>\$ 8,050</u>	+	<u>\$1,400</u>	+	<u>\$1,600</u>	+	<u>\$7,000</u>	=	<u>\$1,600</u>	+	<u>\$15,000</u>	-	<u>\$1,300</u>	+	<u>\$4,700</u>	-	<u>\$1,950</u>		
	\$18,050								\$18,050										

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

ACTION PLAN

- Analyze the effects of each transaction on the accounting equation.
- Use appropriate category names (not descriptions).
- Keep the accounting equation in balance.

DO IT! 4 | Tabular Analysis

Transactions made by Virmari & Co., a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1.9.

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

Solution

Trans- action	Assets		=	Liabilities	+	Owner's Equity			
	Cash	+ Equipment	=	Accounts Payable	+	Owner's Capital	- Owner's Drawings	+ Revenues	- Expenses
(1)	+\$25,000					+\$25,000			
(2)		+\$7,000		+\$7,000					
(3)	+8,000							+\$8,000	
(4)	-850								-\$850
(5)	-1,000						-\$1,000		
	<u>\$31,150</u>	+ <u>\$7,000</u>	=	<u>\$7,000</u>	+ <u>\$25,000</u>	- <u>\$1,000</u>	+ <u>\$8,000</u>	- <u>\$850</u>	
	\$38,150			\$38,150					

Related exercise material: BE1.7, BE1.9, DO IT! 1.4, E1.6, E1.7, and E1.8.

The Four Financial Statements

LEARNING OBJECTIVE 5

Describe the four financial statements and how they are prepared.

HELPFUL HINT

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

Companies prepare four financial statements from the summarized accounting data (see **Helpful Hint**):

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

These statements provide relevant financial data for internal and external users. **Illustration 1.10** shows the financial statements of Softbyte.

ILLUSTRATION 1.10**Financial statements and their interrelationships**

Softbyte
Income Statement
For the Month Ended September 30, 2022

Revenues		
Service revenue		\$4,700
Expenses		
Salaries and wages expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Net income		<u>\$2,750</u>

Softbyte
Owner's Equity Statement
For the Month Ended September 30, 2022

Owner's capital, September 1		\$ -0-
Add: Investments	\$15,000	
Net income	<u>2,750</u>	<u>17,750</u>
		17,750
Less: Drawings		<u>1,300</u>
Owner's capital, September 30		<u>\$16,450</u>

Softbyte
Balance Sheet
September 30, 2022

<u>Assets</u>		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u>\$18,050</u>
<u>Liabilities and Owner's Equity</u>		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
Owner's capital		<u>16,450</u>
Total liabilities and owner's equity		<u>\$18,050</u>

Softbyte
Statement of Cash Flows
For the Month Ended September 30, 2022

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

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

1

If a section has two or more items, a subtotal to the left may be included.

2

Note that final sums are double-underlined, and negative amounts (see the statement of cash flows) are presented in parentheses.

3

The arrows show the interrelationships of the four financial statements.

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

Note that the statements shown in Illustration 1.10 are interrelated:

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

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

Be sure to carefully examine the format and content of each statement in Illustration 1.10. We describe the essential features of each in the following sections.

Income Statement

ALTERNATIVE TERMINOLOGY

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

Alternative Terminology notes present synonymous terms that you may come across in practice.

The income statement reports the success or profitability of the company's operations over a specific period of time (see **Alternative Terminology**). For example, Softbyte's income statement is dated "For the Month Ended September 30, 2022."

- It is prepared from the data appearing in the revenue and expense columns of the tabular summary in Illustration 1.9.
- The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

The income statement lists revenues first, followed by expenses. Finally, the statement shows net income (or net loss).

- When revenues exceed expenses, **net income** results.
- When expenses exceed revenues, a **net loss** results.

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

Note that the income statement does not include investment and withdrawal transactions between the owner and the business in measuring net income. For example, as explained earlier, Ray Neal's withdrawal of cash from Softbyte was not regarded as a business expense. This type of transaction is considered a reduction of owner's capital, which causes a decrease in owner's equity.

Owner's Equity Statement

The owner's equity statement reports the changes in owner's equity for a specific period of time. The time period is the same as that covered by the income statement (in Softbyte's case, this is "For the Month Ended September 30, 2022").

- Data for the preparation of the owner's equity statement come from the owner's equity columns of the tabular summary (Illustration 1.9) and from the income statement.
- The first line of the statement shows the beginning owner's equity amount (which was zero at the start of the business).
- Then come the owner's investments, net income (or loss), and the owner's drawings.

This statement indicates why owner's equity has increased or decreased during the period.

What if Softbyte had reported a net loss in its first month? Let's assume that during the month of September 2022, Softbyte lost \$10,000. **Illustration 1.11** shows the presentation of a net loss in the owner's equity statement.

Softbyte
Owner's Equity Statement
For the Month Ended September 30, 2022

Owner's capital, September 1	\$ -0-	
Add: Investments	<u>15,000</u>	15,000
Less: Drawings	\$ 1,300	
Net loss	<u>10,000</u>	<u>11,300</u>
Owner's capital, September 30		<u><u>\$ 3,700</u></u>

ILLUSTRATION 1.11
Presentation of net loss

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

Balance Sheet

Softbyte's balance sheet reports the assets, liabilities, and owner's equity at a specific date (in Softbyte's case, September 30, 2022). The company prepares the balance sheet from the column headings of the tabular summary (Illustration 1.9) and the month-end data shown in its last line.

Observe that the balance sheet lists assets at the top, followed by liabilities and owner's equity. **Total assets must equal total liabilities and owner's equity.** Softbyte reports only one liability—accounts payable—in its balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in **Illustration 1.12**.

Liabilities	
Notes payable	\$10,000
Accounts payable	63,000
Salaries and wages payable	<u>18,000</u>
Total liabilities	<u>\$91,000</u>

ILLUSTRATION 1.12
Presentation of liabilities

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

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 a company for a specific period of time (see **Helpful Hint**).

- To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's operating, investing, and financing activities.
- The statement shows the net increase or decrease in cash during the period, and the amount of cash at the end of the period.

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

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

HELPFUL HINT

The statement of cash flows helps users determine if the company generates enough cash from operations to fund its investing and financing activities.

As shown in Softbyte’s statement of cash flows in Illustration 1.10, cash increased \$8,050 during the period. Net cash provided by operating activities increased cash \$1,350 (cash receipts from revenue less cash payments for expenses). Cash flow from investing activities decreased cash \$7,000 (purchase of equipment). And cash flow from financing activities increased cash \$13,700 (investment by owner less drawings by owner). At this time, you need not be concerned with how these amounts are determined. Chapter 17 will examine the statement of cash flows in detail.

Financial Statements: Order of Preparation

The financial statements are prepared in a specific order. The order is important because of the financial statement interrelationships we discussed earlier (and shown in Illustration 1.10). That is:

- The net income or net loss is needed from the income statement to prepare the owner’s equity statement.
- The ending owner’s capital balance is needed from the owner’s equity statement to prepare the balance sheet.
- The amount of cash on the balance sheet should agree with the ending cash balance on the statement of cash flows.

The order of preparation and interrelationships among the statements is shown in **Illustration 1.13**.

ILLUSTRATION 1.13 Preparation order and summary of the four financial statements

Financial statement	Income Statement	Owner’s Equity Statement	Balance Sheet	Statement of Cash Flows
Timeframe	Period of time	Period of time	Point in time	Period of time
Format	$\begin{array}{r} \text{Revenues} \\ - \text{Expenses} \\ \hline \text{Net income/} \\ \text{(net loss)} \end{array}$	$\begin{array}{r} \text{Beg. owner’s capital} \\ + \text{Investments} \\ \hline \text{+/- Net income/(net loss)} \\ - \text{Drawings} \\ \hline \text{End. owner’s capital} \end{array}$	$\begin{array}{r} \text{Assets =} \\ \text{Liabilities} \\ + \text{Owner’s} \\ \text{equity} \end{array}$	$\begin{array}{r} \text{+/- Operating cash flows} \\ \text{+/- Investing cash flows} \\ \text{+/- Financing cash flows} \\ \hline \text{Net incr./decr.) in cash} \\ + \text{Beg. cash} \\ \hline \text{End. cash} \end{array}$

People, Planet, and Profit Insight



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Beyond Financial Statements

Should we expand our financial statements beyond the income statement, owner’s equity statement, balance sheet, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial results, in evaluating a company. The argument is that a company’s responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing stockholders’ interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides

safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But many interesting and useful efforts are underway. Throughout this text, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to stockholders.

Why might a company’s stockholders be interested in its environmental and social performance? (Answer is available near the end of the chapter.)

DO IT! 5 | Financial Statement Items

Presented below is selected information related to Flanagan Company at December 31, 2022. Flanagan reports financial information monthly.

Equipment	\$10,000	Utilities Expense	\$ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Owner's Drawings	6,000

- Determine the total assets of Flanagan Company at December 31, 2022.
- Determine the net income that Flanagan Company reported for December 2022.
- Determine the owner's equity of Flanagan Company at December 31, 2022.

ACTION PLAN

- Remember the basic accounting equation: **assets must equal liabilities plus owner's equity.**
- Review previous financial statements to determine how total assets, net income, and owner's equity are computed.

Solution

- The total assets are \$27,000, comprised of Cash \$8,000, Accounts Receivable \$9,000, and Equipment \$10,000.
- Net income is \$14,000, computed as follows.

Revenues		
Service revenue		\$36,000
Expenses		
Rent expense	\$11,000	
Salaries and wages expense	7,000	
Utilities expense	<u>4,000</u>	
Total expenses		<u>22,000</u>
Net income		<u>\$14,000</u>

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

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

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

Related exercise material: **BE1.10, BE1.11, DO IT! 1.5, E1.9, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, E1.16, E1.17, and E1.18**

Appendix 1A**Career Opportunities in Accounting****LEARNING OBJECTIVE *6**

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice?

- There are a lot of jobs.** In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, "accounting is one degree with 360 degrees of opportunity."

2. **Accounting matters.** Interest in accounting has increased, ironically, because of the attention caused by the accounting failures of companies such as **Enron** and **WorldCom**. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society.
3. **The Sarbanes-Oxley Act (SOX) significantly increased the accounting and internal control requirements for corporations.** This dramatically increased demand for professionals with accounting training.
4. **Emerging technologies such as automation, blockchain, and data analytics are changing the way accountants work.** With those skills, accountants add value to business decision-making.

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

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients.

- A major portion of public accounting involves **auditing**. In auditing, a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position. Analysts, investors, and creditors rely heavily on these "audit opinions," which CPAs have the exclusive authority to issue.
- **Taxation** is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies such as the Internal Revenue Service.
- A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to performing support services for major marketing projects and merger and acquisition activities.

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

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Starbucks**, **Google**, or **PepsiCo**. Financial accountants manage the accounting information system and prepare financial statements.

- In **managerial accounting** (private), you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, and tax planning and preparation.
- You might also be a member of your company's internal audit team. In response to SOX, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

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

Governmental Accounting

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, the Internal Revenue Service (IRS), Federal Bureau of Investigation (FBI), and Securities and Exchange Commission (SEC) all employ accountants.

- The FBI reports that approximately 15% of agents qualify as special agent accountants.
- There is also a very high demand for accounting educators at public colleges and universities and in state and local governments.

Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future.

- The job of forensic accountants is to catch the perpetrators of the estimated \$600 billion per year of theft and fraud occurring at U.S. companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion.
- Insurance companies hire forensic accountants to detect frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.
- Forensic accountants often have FBI, IRS, or similar government experience.

“Show Me the Money”

How much can a new accountant make? Take a look at the average salaries for college graduates in public and private accounting shown in **Illustration 1A.1**.³ Keep in mind if you also have a CPA license, you’ll make 10–15% more when you start out.

Employer	Jr. Level (0–3 yrs.)	Sr. Level (4–6 yrs.)
Public accounting (large firm)	\$63,250–\$83,250	\$78,500–\$106,500
Public accounting (medium firm)	\$56,500–\$67,750	\$70,500–\$96,000
Public accounting (small company)	\$51,500–\$60,500	\$63,750–\$81,500
Corporate accounting (large company)	\$53,750–\$69,500	\$68,750–\$87,750

ILLUSTRATION 1A.1 Salary estimates for jobs in public and corporate accounting

Illustration 1A.2 lists some examples of upper-level salaries for managers in corporate accounting. Note that geographic region, experience, education, CPA certification, and company size each play a role in determining salary.

Position	Large Company	Small to Medium Company
Chief financial officer	\$207,000–\$465,750	\$105,250–\$208,750
Corporate controller	\$140,000–\$224,750	\$92,000–\$161,250
Tax manager	\$112,000–\$158,250	\$88,000–\$124,750

ILLUSTRATION 1A.2 Upper-level management salaries in corporate accounting

Review and Practice

The Review and Practice section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, brief exercises, exercises, and a comprehensive problem. Detailed solutions are also included.

Learning Objectives Review

1 Identify the activities and users associated with accounting.

Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users. The major users and uses of accounting are as follows. (a) Management uses accounting information to plan, organize, and run

³See starthergoplaces.com/students/why-accounting/salary-and-demand/ for information regarding the salaries listed in Illustrations 1A.1 and 1A.2.

the business. (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, and labor unions.

2 Explain the building blocks of accounting: ethics, principles, and assumptions.

Ethics are the standards of conduct by which actions are judged as right or wrong. Effective financial reporting depends on sound ethical behavior.

Generally accepted accounting principles are a common set of standards used by accountants. The primary accounting standard-setting body in the United States is the Financial Accounting Standards Board. The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

3 State the accounting equation, and define its components.

The basic accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

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

The expanded accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Capital} - \text{Owner's Drawings} + \text{Revenues} - \text{Expenses}$$

Investments by owners (assets the owner puts into the business) are recorded in a category called owner's capital. Owner's drawings are the withdrawal of assets by the owner for personal use. Revenues are the gross increase in owner's equity from business activities for the purpose of earning income. Expenses are the costs of assets consumed or services used in the process of earning revenue. Owner's equity is increased by an owner's investments and by revenues from business operations. Owner's equity is decreased by an owner's withdrawals of assets and by expenses.

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

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

5 Describe the four financial statements and how they are prepared.

An income statement presents the revenues and expenses, and resulting net income or net loss, for a specific period of time. An owner's equity statement summarizes the changes in owner's equity for a specific period of time. A balance sheet reports the assets, liabilities, and owner's equity 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.

*6 Explain the career opportunities in accounting.

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

Glossary Review

Accounting The information system that identifies, records, and communicates the economic events of an organization to interested users. (p. 1-3).

Accounting information system The system of collecting and processing transaction data and communicating financial information to decision-makers. (p. 1-15)

Assets Resources a business owns. (p. 1-13).

***Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 1-28).

Balance sheet A financial statement that reports the assets, liabilities, and owner's equity at a specific date. (p. 1-22).

Basic accounting equation $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$. (p. 1-12).

Bookkeeping A part of the accounting process that involves only the recording of economic events. (p. 1-4).

Corporation A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock. (p. 1-11).

Data analytics The use of software and statistics to draw inferences from data. (p. 1-4).

Drawings Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s). (p. 1-14).

Economic entity assumption An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. (p. 1-10).

Ethics The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair. (p. 1-7).

Expanded accounting equation $\text{Assets} = \text{Liabilities} + \text{Owner's capital} - \text{Owner's drawings} + \text{Revenues} - \text{Expenses}$. (p. 1-14).

Expenses The cost of assets consumed or services used in the process of generating revenue. (p. 1-14).

Fair value principle An accounting principle stating that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). (p. 1-10).

Faithful representation Numbers and descriptions match what really existed or happened—they are factual. (p. 1-9).

Financial accounting The field of accounting that provides economic and financial information for investors, creditors, and other external users. (p. 1-6).

Financial Accounting Standards Board (FASB) A private organization that establishes generally accepted accounting principles (GAAP) in the United States. (p. 1-8).

***Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-29).

Generally accepted accounting principles (GAAP) Common standards that indicate how to report economic events. (p. 1-8).

Historical cost principle An accounting principle that states that companies should record assets at their cost. (p. 1-9).

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. 1-22).

International Accounting Standards Board (IASB) An accounting standard-setting body that issues standards adopted by many countries outside of the United States. (p. 1-8).

International Financial Reporting Standards (IFRS) International accounting standards set by the International Accounting Standards Board (IASB). (p. 1-8).

Investments by owner The assets an owner puts into the business. (p. 1-14).

Liabilities Creditor claims against total assets. (p. 1-13).

***Management consulting** An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 1-28).

Managerial accounting The field of accounting that provides internal reports to help users make decisions about their companies. (p. 1-5).

Monetary unit assumption An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money. (p. 1-10).

Net income The amount by which revenues exceed expenses. (p. 1-24).

Net loss The amount by which expenses exceed revenues. (p. 1-24).

Owner's equity The ownership claim on total assets. (p. 1-13).

Owner's equity statement A financial statement that summarizes the changes in owner's equity for a specific period of time. (p. 1-22).

Partnership A business owned by two or more persons associated as partners. (p. 1-11).

Proprietorship A business owned by one person. (p. 1-10).

***Public accounting** An area of accounting in which the accountant offers expert service to the general public. (p. 1-28).

Relevance Financial information that is capable of making a difference in a decision. (p. 1-9).

Revenues The increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business. (p. 1-14).

Sarbanes-Oxley Act (SOX) Law passed by Congress intended to reduce unethical corporate behavior. (p. 1-7).

Securities and Exchange Commission (SEC) A governmental agency that oversees U.S. financial markets and accounting standard-setting bodies. (p. 1-8).

Statement of cash flows A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time. (p. 1-22).

***Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-28).

Transactions The economic events of a business that are recorded by accountants. (p. 1-16).

Practice Multiple-Choice Questions

1. (LO 1) Which of the following is **not** a step in the accounting process?

- a. Identification.
- b. Economic entity.
- c. Recording.
- d. Communication.

2. (LO 1) Which of the following statements about users of accounting information is **incorrect**?

- a. Management is an internal user.
- b. Taxing authorities are external users.
- c. Present creditors are external users.
- d. Regulatory authorities are internal users.

3. (LO 2) The historical cost principle states that:

- a. assets should be initially recorded at cost and adjusted when the fair value changes.
- b. activities of an entity are to be kept separate and distinct from its owner.

c. assets should be recorded at their cost.

d. only transaction data capable of being expressed in terms of money be included in the accounting records.

4. (LO 2) Which of the following statements about basic assumptions is **correct**?

- a. Basic assumptions are the same as accounting principles.
- b. The economic entity assumption states that there should be a particular unit of accountability.
- c. The monetary unit assumption enables accounting to measure employee morale.
- d. Partnerships are not economic entities.

5. (LO 2) The three types of business entities are:

- a. proprietorships, small businesses, and partnerships.
- b. proprietorships, partnerships, and corporations.
- c. proprietorships, partnerships, and large businesses.
- d. financial, manufacturing, and service companies.

6. (LO 3) Net income will result during a time period when:
- assets exceed liabilities.
 - assets exceed revenues.
 - expenses exceed revenues.
 - revenues exceed expenses.
7. (LO 3) As of December 31, 2022, Kent Company has assets of \$3,500 and owner's equity of \$2,000. What are the liabilities for Kent Company as of December 31, 2022?
- \$1,500.
 - \$1,000.
 - \$2,500.
 - \$2,000.
8. (LO 4) Performing services on account will have the following effects on the components of the basic accounting equation:
- increase assets and decrease owner's equity.
 - increase assets and increase owner's equity.
 - increase assets and increase liabilities.
 - increase liabilities and increase owner's equity.
9. (LO 4) Which of the following events is **not** recorded in the accounting records?
- Equipment is purchased on account.
 - An employee is terminated.
 - A cash investment is made into the business.
 - The owner withdraws cash for personal use.
10. (LO 4) During 2022, Bruske Company's assets decreased \$50,000 and its liabilities decreased \$50,000. Its owner's equity therefore:
- increased \$50,000.
 - decreased \$50,000.
 - decreased \$100,000.
 - did not change.
11. (LO 4) Payment of an account payable affects the components of the accounting equation in the following way.
- Decreases owner's equity and decreases liabilities.
 - Increases assets and decreases liabilities.
 - Decreases assets and increases owner's equity.
 - Decreases assets and decreases liabilities.
12. (LO 5) Which of the following statements is **false**?
- A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
 - A balance sheet reports the assets, liabilities, and owner's equity at a specific date.
 - An income statement presents the revenues, expenses, changes in owner's equity, and resulting net income or net loss for a specific period of time.
 - An owner's equity statement summarizes the changes in owner's equity for a specific period of time.
13. (LO 5) On the last day of the period, Alan Cesska Company buys a \$900 machine on credit. This transaction will affect the:
- income statement only.
 - balance sheet only.
 - income statement and owner's equity statement only.
 - income statement, owner's equity statement, and balance sheet.
14. (LO 5) The financial statement that reports assets, liabilities, and owner's equity is the:
- income statement.
 - owner's equity statement.
 - balance sheet.
 - statement of cash flows.
- *15. (LO 6) Services performed by a public accountant include:
- auditing, taxation, and management consulting.
 - auditing, budgeting, and management consulting.
 - auditing, budgeting, and cost accounting.
 - auditing, budgeting, and management consulting.

Solutions

1. **b.** Economic entity is not one of the steps in the accounting process. The other choices are true because (a) identification is the first step in the accounting process, (c) recording is the second step in the accounting process, and (d) communication is the third and final step in the accounting process.
2. **d.** Regulatory authorities are external, not internal, users of accounting information. The other choices are true statements.
3. **c.** The historical cost principle states that assets should be recorded at their cost. The other choices are incorrect because (a) the historical cost principle does not say that assets should be adjusted for changes in fair value, (b) describes the economic entity assumption, and (d) describes the monetary unit assumption.
4. **b.** The economic entity assumption states that there should be a particular unit of accountability. The other choices are incorrect because (a) basic assumptions are not the same as accounting principles, (c) the monetary unit assumption allows accounting to measure economic events, and (d) partnerships are economic entities.
5. **b.** Proprietorships, partnerships, and corporations are the three types of business entities. Choices (a) and (c) are incorrect because small and large businesses only denote the sizes of businesses. Choice (d) is incorrect because financial, manufacturing, and service companies are types of businesses, not business entities.
6. **d.** Net income results when revenues exceed expenses. The other choices are incorrect because (a) assets and liabilities are not used in the computation of net income; (b) revenues, not assets, are included in the computation of net income; and (c) when expenses exceed revenues, a net loss results.
7. **a.** Using a variation of the basic accounting equation, Assets – Owner's equity = Liabilities, $\$3,500 - \$2,000 = \$1,500$. Therefore, choices (b) \$1,000, (c) \$2,500, and (d) \$2,000 are incorrect.
8. **b.** When services are performed on account, assets are increased and owner's equity is increased. The other choices are incorrect because when services are performed on account (a) owner's equity is increased, not decreased; (c) liabilities are not affected; and (d) owner's equity is increased and liabilities are not affected.

9. b. If an employee is terminated, this represents an activity of a company, not a business transaction. Assets, liabilities, and owner's equity are not affected. Thus, there is no effect on the accounting equation. The other choices are incorrect because they are all recorded: (a) when equipment is purchased on account, both assets and liabilities increase; (c) when a cash investment is made into a business, both assets and owner's equity increase; and (d) when an owner withdraws cash for personal use, both assets and owner's equity decrease.

10. d. In this situation, owner's equity does not change because only assets and liabilities decreased \$50,000. Therefore, the other choices are incorrect.

11. d. Payment of an account payable results in an equal decrease of assets (cash) and liabilities (accounts payable). The other choices are incorrect because payment of an account payable (a) does not affect owner's equity, (b) does not increase assets, and (c) does not affect owner's equity.

12. c. An income statement represents the revenues, expenses, and the resulting net income or net loss for a specific period of time

but not the changes in owner's equity. The other choices are true statements.

13. b. This transaction will cause assets to increase by \$900 and liabilities to increase by \$900. The other choices are incorrect because this transaction (a) will have no effect on the income statement, (c) will have no effect on the income statement or the owner's equity statement, and (d) will affect the balance sheet but not the income statement or the owner's equity statement.

14. c. The balance sheet is the statement that reports assets, liabilities and owner's equity. The other choices are incorrect because (a) the income statement reports revenues and expenses, (b) the owner's equity statement reports details about owner's equity, and (d) the statement of cash flows reports inflows and outflows of cash.

***15. a.** Auditing, taxation, and management consulting are all services performed by public accountants. The other choices are incorrect because public accountants do not perform budgeting or cost accounting.

Practice Brief Exercises

1. (LO 3) At the beginning of the year, Ortiz Company had total assets of \$900,000 and total liabilities of \$440,000. Answer the following questions.

Use basic accounting equation.

- If total assets decreased \$100,000 during the year and total liabilities increased \$80,000 during the year, what is the amount of owner's equity at the end of the year?
- During the year, total liabilities decreased \$100,000 and owner's equity increased \$200,000. What is the amount of total assets at the end of the year?
- If total assets increased \$50,000 during the year and owner's equity increased \$60,000 during the year, what is the amount of total liabilities at the end of the year?

Solution

- $(\$900,000 - \$440,000) - \$100,000 - \$80,000 = \$280,000$ owner's equity
 - $\$900,000 - \$100,000 + \$200,000 = \$1,000,000$ total assets
 - $\$440,000 - \$60,000 + \$50,000 = \$430,000$ total liabilities

2. (LO 4) The following are three business transactions. List the letters (a), (b), and (c) with columns for assets, liabilities and owner's equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and owner's equity.

Determine effect of transactions on basic accounting equation

- Purchased equipment on account.
- Withdrawal of cash by owner.
- Paid expenses in cash.

Solution

	<u>Assets</u>	<u>Liabilities</u>	<u>Owner's Equity</u>
2. a.	+	+	NE
b.	−	NE	−
c.	−	NE	−

Determine effect of transactions on basic accounting equation.

3. (LO 4) Follow the same format as in **Practice Brief Exercise 2**. Determine the effect on assets, liabilities, and owner's equity of the following three transactions.
- Performed accounting services for clients for cash.
 - Borrowed cash from a bank on a note payable.
 - Paid cash for rent for the month.

Solution

	<u>Assets</u>	<u>Liabilities</u>	<u>Owner's Equity</u>
3. a.	+	NE	+
b.	+	+	NE
c.	-	NE	-

Determine where items appear on financial statements.

4. (LO 5) **Financial Statement** Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or owner's equity statement (OE).
- Owner's capital.
 - Cash.
 - Salaries and wages expense.
 - Service revenue.
 - Accounts payable.

Solution

4. a.	Owner's capital	<u>OE, BS</u>
b.	Cash	<u>BS</u>
c.	Salaries and wages expense	<u>IS</u>
d.	Service revenue	<u>IS</u>
e.	Accounts payable	<u>BS</u>

Prepare a balance sheet.

5. (LO 5) **Financial Statement** Presented below in alphabetical order are balance sheet items for Feagler Company at December 31, 2022. Carole Feagler is the owner of the company. Prepare a balance sheet following the format of Illustration 1.10.

Accounts receivable	\$12,500
Cash	38,000
Notes payable	40,000
Owner's capital	10,500

Solution

5.

Feagler Company Balance Sheet December 31, 2022	
<u>Assets</u>	
Cash	\$38,000
Accounts receivable	<u>12,500</u>
Total assets	<u>\$50,500</u>
<u>Liabilities and Owner's Equity</u>	
Liabilities	
Notes payable	\$40,000
Owner's equity	
Owner's capital	<u>10,500</u>
Total liabilities and owner's equity	<u>\$50,500</u>

Practice Exercises

1. (LO 3, 4) Selected transactions for Fabulous Flora Company are as follows.

Analyze the effect of transactions.

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

Instructions

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

Solution

1. 1. Increase in assets and increase in owner's equity.
2. Increase in assets and increase in liabilities.
3. Decrease in assets and decrease in owner's equity.
4. Increase in assets and increase in owner's equity.
5. Increase in assets and decrease in assets.
6. Decrease in assets and decrease in owner's equity.
7. Increase in liabilities and decrease in owner's equity.
8. Increase in assets and decrease in assets.
9. Increase in assets and increase in owner's equity.

2. (LO 3, 4) Alma's Payroll Services Company entered into the following transactions during May 2022.

Analyze the effect of transactions on assets, liabilities, and owner's equity.

1. Purchased computers for \$15,000 from Bytes of Data on account.
2. Paid \$3,000 cash for May rent on storage space.
3. Received \$12,000 cash from customers for contracts billed in April.
4. Performed payroll services for Magic Construction Company for \$2,500 cash.
5. Paid Northern Ohio Power Co. \$7,000 cash for energy usage in May.
6. Alma invested an additional \$25,000 in the business.
7. Paid Bytes of Data for the computers purchased in (1) above.
8. Incurred advertising expense for May of \$900 on account.

Instructions

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

- a. an increase in assets and a decrease in assets.
- b. an increase in assets and an increase in owner's equity.
- c. an increase in assets and an increase in liabilities.
- d. a decrease in assets and a decrease in owner's equity.

- e. a decrease in assets and a decrease in liabilities.
- f. an increase in liabilities and a decrease in owner's equity.
- g. an increase in owner's equity and a decrease in liabilities.

Solution

2. 1. c 3. a 5. d 7. e
 2. d 4. b 6. b 8. f

Practice Problem

Prepare a tabular presentation and financial statements.

(LO 4, 5) Joan Robinson opens her own law office on July 1, 2022. During the first month of operations, the following transactions occurred.

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

Instructions

- a. Prepare a tabular summary of the transactions.
- b. **Financial Statement** Prepare the income statement, owner's equity statement, and balance sheet at July 31, 2022, for Joan Robinson, Attorney.

Solution

a. Transaction	Assets			=	Liabilities		+	Owner's Equity		
	Cash	+ Accounts Receivable	+ Equipment	=	Notes Payable	+ Accounts Payable	+	Owner's Capital	- Owner's Drawings	+ Revenues - Expenses
1.	+\$11,000			=				\$11,000		
2.	-800									-\$800
3.			+\$3,000	=		+\$3,000				
4.	+1,500									+\$1,500
5.	+700				+\$700					
6.		+\$2,000								+\$2,000
7.	-900									-500 -300 -100
8.	-1,000								-\$1,000	
	<u>\$10,500</u>	+ <u>\$2,000</u>	+ <u>\$3,000</u>	=	<u>\$700</u>	+ <u>\$3,000</u>	+ <u>\$11,000</u>	- <u>\$1,000</u>	+ <u>\$3,500</u>	- <u>\$1,700</u>
	\$15,500				\$15,500					

b.

Joan Robinson, Attorney		
Income Statement		
For the Month Ended July 31, 2022		
Revenues		
Service revenue		\$3,500
Expenses		
Rent expense	\$800	
Salaries and wages expense	500	
Utilities expense	300	
Advertising expense	<u>100</u>	
Total expenses		<u>1,700</u>
Net income		<u>\$1,800</u>
Joan Robinson, Attorney		
Owner's Equity Statement		
For the Month Ended July 31, 2022		
Owner's capital, July 1		\$ 0
Add: Investments	\$11,000	
Net income	<u>1,800</u>	<u>12,800</u>
		12,800
Less: Drawings		<u>1,000</u>
Owner's capital, July 31		<u>\$11,800</u>
Joan Robinson, Attorney		
Balance Sheet		
July 31, 2022		
<u>Assets</u>		
Cash		\$10,500
Accounts receivable		2,000
Equipment		<u>3,000</u>
Total assets		<u>\$15,500</u>
<u>Liabilities and Owner's Equity</u>		
Liabilities		
Notes payable		\$ 700
Accounts payable		<u>3,000</u>
Total liabilities		3,700
Owner's equity		
Owner's capital		<u>11,800</u>
Total liabilities and owner's equity		<u>\$15,500</u>

Brief Exercises, DO IT! Exercises, Exercises, Problems, Data Analytics Activities, and many additional resources are available for practice in WileyPLUS.

Note: All asterisked Questions, Exercises, and Problems relate to material in the appendix to the chapter.

Questions

- “Accounting is ingrained in our society and it is vital to our economic system.” Explain why this statement is true or false.
- Identify and describe the activities in the accounting process.
- (a) Who are internal users of accounting data? (b) How does accounting provide relevant data to these users?
- What uses of financial accounting information are made by (a) investors and (b) creditors?
- “Bookkeeping and accounting are the same.” Explain why this statement is true or false.
- Benton Travel Agency purchased land for \$90,000 cash on December 10, 2022. At December 31, 2022, the land’s value has increased to \$92,000. What amount should be reported for land on Benton’s balance sheet at December 31, 2022? Explain.
- What is the monetary unit assumption?
- What is the economic entity assumption?
- What are the three basic forms of business organizations for profit-oriented enterprises?
- Helen Rupp is the owner of a successful printing shop. Recently, her business has been increasing, and Helen has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Helen would enjoy if she were to incorporate her business.
- Express the basic accounting equation.
- Define the terms assets, liabilities, and owner’s equity.
 - What items affect owner’s equity?
- Which of the following items are liabilities of Siebers Jewelry Stores?
 - Cash.
 - Accounts payable.
 - Owner’s drawings.
 - Accounts receivable.
 - Supplies.
 - Equipment.
 - Salaries and wages payable.
 - Service revenue.
 - Rent expense.
- Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.
- Are the following events recorded in the accounting records? Explain your answer in each case.
 - The owner of the company dies.
 - Supplies are purchased on account.
 - An employee is fired.
 - The owner of the business withdraws cash from the business for personal use.
- Indicate how the following business transactions affect the basic accounting equation.
 - Paid cash for janitorial services.
 - Purchased equipment for cash.
 - Invested cash in the business.
 - Paid accounts payable in full.
- Listed below are some items found in the financial statements of Tony Gruber Co. Indicate in which financial statement(s) the following items would appear.
 - Service revenue.
 - Equipment.
 - Advertising expense.
 - Accounts receivable.
 - Owner’s capital.
 - Salaries and wages payable.
- In February 2022, Ola Gott invested an additional \$12,000 in her business, Gott’s Pharmacy, which is organized as a proprietorship. Gott’s accountant, Sal Costa, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?
- “A company’s net income appears directly on the income statement and the owner’s equity statement, and it is included indirectly in the company’s balance sheet.” Do you agree? Explain.
- Bayler Enterprises had a capital balance of \$186,000 at the beginning of the period. At the end of the accounting period, the capital balance was \$189,000.
 - Assuming no additional investment or withdrawals during the period, what is the net income for the period?
 - Assuming an additional investment of \$13,000 but no withdrawals during the period, what is the net income or net loss for the period?
- Summarized operations for Bayles Co. for the month of July are as follows.

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

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

Indicate for Bayles Co. (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.
- The basic accounting equation is $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$. Replacing the words in that equation with dollar amounts, what is **Apple’s** accounting equation at September 28, 2019? (*Hint: Owner’s equity is equivalent to shareholders’ equity.*)

Brief Exercises

BE1.1 (LO 3), AP The following is the basic accounting equation. Determine the missing amounts.

Use basic accounting equation.

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
a.	\$90,000		\$50,000		?
b.	?		\$44,000		\$70,000
c.	\$94,000		?		\$53,000

BE1.2 (LO 3), AP Given the accounting equation, answer each of the following questions.

Use basic accounting equation.

- The liabilities of Berber Company are \$120,000 and the owner's equity is \$230,000. What is the amount of Berber Company's total assets?
- The total assets of Berber Company are \$190,000 and its owner's equity is \$89,000. What is the amount of its total liabilities?
- The total assets of Berber Company are \$900,000 and its liabilities are equal to one-half of its total assets. What is the amount of Berber Company's owner's equity?

BE1.3 (LO 3), AP At the beginning of the year, Gilles Company had total assets of \$800,000 and total liabilities of \$300,000. Answer the following questions.

Use basic accounting equation.

- If total assets increased \$150,000 during the year and total liabilities decreased \$60,000, what is the amount of owner's equity at the end of the year?
- During the year, total liabilities increased \$100,000 and owner's equity decreased \$70,000. What is the amount of total assets at the end of the year?
- If total assets decreased \$80,000 and owner's equity increased \$120,000 during the year, what is the amount of total liabilities at the end of the year?

BE1.4 (LO 3), AP Use the expanded accounting equation to answer each of the following questions.

Solve expanded accounting equation.

- The liabilities of Platt Company are \$90,000. Owner's capital is \$150,000; drawings are \$40,000; revenues, \$450,000; and expenses, \$340,000. What is the amount of Platt Company's total assets?
- The total assets of Sierra Company are \$57,000. Owner's capital is \$35,000; drawings are \$7,000; revenues, \$52,000; and expenses, \$35,000. What is the amount of the company's total liabilities?
- The total assets of Birch Co. are \$660,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Birch Co.'s owner's equity?

BE1.5 (LO 3), C Indicate whether each of the following items is an asset (A), liability (L), or part of owner's equity (OE).

Identify assets, liabilities, and owner's equity.

- | | |
|-------------------------------------|--------------------------|
| _____ a. Accounts receivable | _____ d. Supplies |
| _____ b. Salaries and wages payable | _____ e. Owner's capital |
| _____ c. Equipment | _____ f. Notes payable |

BE1.6 (LO 3), C Classify each of the following items as owner's drawings (D), revenue (R), or expense (E).

Classify items affecting owner's equity.

- | | |
|-------------------------------------|----------------------------|
| _____ a. Advertising expense | _____ e. Owner's drawings |
| _____ b. Service revenue | _____ f. Rent revenue |
| _____ c. Insurance expense | _____ g. Utilities expense |
| _____ d. Salaries and wages expense | |

BE1.7 (LO 4), C The following are three business transactions. On a sheet of paper, list the letters (a), (b), and (c) with columns for assets, liabilities, and owner's equity. For each column, indicate whether the transactions increased (+), decreased (-), or had no effect (NE) on assets, liabilities, and owner's equity.

Determine effect of transactions on basic accounting equation.

- Purchased supplies on account.
- Received cash for performing a service.
- Paid expenses in cash.

BE1.8 (LO 4), C Follow the same format as in BE1.7. Determine the effect on assets, liabilities, and owner's equity of the following three transactions.

Determine effect of transactions on basic accounting equation.

- Invested cash in the business.
- Withdrawal of cash by owner.
- Received cash from a customer who had previously been billed for services performed.

Determine effect of transactions on basic owner's equity.

BE1.9 (LO 4), C The following are three transactions. Mark each transaction as affecting owner's investment (I), owner's drawings (D), revenue (R), expense (E), or not affecting owner's equity (NOE).

- _____ a. Received cash for services performed
- _____ b. Paid cash to purchase equipment
- _____ c. Paid employee salaries

Prepare a balance sheet.

BE1.10 (LO 5), AP Financial Statement In alphabetical order below are balance sheet items for Smyth Company at December 31, 2022. Kathy Smyth is the owner of Smyth Company. Prepare a balance sheet following the format of Illustration 1.10.

Accounts payable	\$90,000
Accounts receivable	62,500
Cash	49,000
Owner's capital	21,500

Determine where items appear on financial statements.

BE1.11 (LO 5), C Financial Statement Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or owner's equity statement (OE).

- _____ a. Notes payable
- _____ b. Advertising expense
- _____ c. Owner's capital
- _____ d. Cash
- _____ e. Service revenue

DO IT! Exercises

Review basic concepts.

DO IT! 1.1 (LO 1), K Indicate whether each of the following five statements is true or false. If false, indicate how to correct the statement.

- The three steps in the accounting process are identification, recording, and examination.
- The accounting process includes the bookkeeping function.
- Managerial accounting provides reports to help investors and creditors evaluate a company.
- The two most common types of external users are investors and creditors.
- Internal users include human resources managers.

Identify building blocks of accounting.

DO IT! 1.2 (LO 2), K Indicate whether each of the following five statements is true or false. If false, indicate how to correct the statement.

- Congress passed the Sarbanes-Oxley Act to ensure that investors invest only in companies that will be profitable.
- The standards of conduct by which actions are judged as loyal or disloyal are ethics.
- The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
- The historical cost principle dictates that companies record assets at their cost and continue to report them at their cost over the time the assets are held.
- The monetary unit assumption requires that companies record only transactions that can be measured in money.

Evaluate effects of transactions on owner's equity.

DO IT! 1.3 (LO 3), K Classify the following items as investment by owner (I), owner's drawings (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases owner's equity.

- Drawings.
- Rent revenue.
- Advertising expense.
- Owner puts personal assets into the business.

Prepare tabular analysis.

DO IT! 1.4 (LO 4), AP Transactions made by A. Marti and Co., a law firm, for the month of March are shown as follows. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1.9.

- The company performed \$20,000 of services for customers, on credit.
- The company received \$20,000 in cash from customers who had been billed for services (in transaction 1).
- The company received a bill for \$3,200 of advertising but will not pay it until a later date.
- A. Marti withdrew \$2,500 cash from the business for personal use.

DO IT! 1.5 (LO 5), AP The following is selected information related to Kirby Company at December 31, 2022. Kirby reports financial information monthly.

Determine specific amounts on the financial statements.

Accounts Payable	\$ 3,000	Salaries and Wages Expense	\$16,500
Cash	6,500	Notes Payable	25,000
Advertising Expense	6,000	Rent Expense	10,500
Service Revenue	53,500	Accounts Receivable	13,500
Equipment	29,000	Owner's Drawings	7,500

- Determine the total assets of Kirby Company at December 31, 2022.
- Determine the net income that Kirby Company reported for December 2022.
- Determine the owner's equity of Kirby Company at December 31, 2022.

Exercises

E1.1 (LO 1), C Genesis Company performs the following accounting tasks during the year.

Classify the three activities of accounting.

- _____ Analyzing and interpreting information.
- _____ Classifying economic events.
- _____ Explaining uses, meaning, and limitations of data.
- _____ Keeping a systematic chronological diary of events.
- _____ Measuring events in dollars and cents.
- _____ Preparing accounting reports.
- _____ Reporting information in a standard format.
- _____ Selecting economic activities relevant to the company.
- _____ Summarizing economic events.

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

Instructions

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

E1.2 (LO 1), C a. The following are users of financial statements.

Identify users of accounting information.

- | | |
|--------------------------------|--|
| _____ Customers | _____ Securities and Exchange Commission |
| _____ Internal Revenue Service | _____ Store manager |
| _____ Labor unions | _____ Suppliers |
| _____ Marketing manager | _____ Vice president of finance |
| _____ Production supervisor | |

Instructions

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

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

- _____ Can we afford to give our employees a pay raise?
- _____ Did the company earn a satisfactory income?
- _____ Do we need to borrow in the near future?
- _____ How does the company's profitability compare to other companies?
- _____ What does it cost us to manufacture each unit produced?
- _____ Which product should we emphasize?
- _____ Will the company be able to pay its short-term debts?

Discuss ethics and the historical cost principle.

Instructions

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

E1.3 (LO 2), C Angela Duffy, president of Duffy Company (a corporation), has instructed Jana Barth, the head of the accounting department for Duffy Company, to report the company's land in the company's accounting reports at its fair value of \$170,000 instead of its cost of \$100,000. Duffy says, "Showing the land at \$170,000 will make our company look like a better investment when we try to attract new investors next month."

Instructions

Explain the ethical situation involved for Jana Barth, identifying the stakeholders and the alternatives.

Use accounting concepts.

E1.4 (LO 2), C The following situations involve accounting principles and assumptions.

1. Sosa Company owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Sosa reports the buildings at fair value in its accounting reports.
2. Mays Company includes in its accounting records only transaction data that can be expressed in terms of money.
3. Curt Russell, owner of Curt's Photography, records his personal living costs as expenses of the business.

Instructions

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

Classify accounts as assets, liabilities, and owner's equity.

E1.5 (LO 3), C Diehl Cleaners has the following balance sheet items.

Accounts payable	Accounts receivable
Cash	Notes payable
Equipment	Salaries and wages payable
Supplies	Owner's capital

Instructions

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

Analyze the effect of transactions.

E1.6 (LO 4), C Selected transactions for Poway Landscaping Company are listed below.

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

Instructions

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

Analyze the effect of transactions on assets, liabilities, and owner's equity.

E1.7 (LO 4), C Falske Computer Timeshare Company entered into the following transactions during May 2022.

1. Purchased computers for \$20,000 from Digital Equipment on account.
2. Paid \$4,000 cash for May rent on storage space.
3. Received \$17,000 cash from customers for contracts billed in April.
4. Performed computer services for Viking Construction Company for \$4,000 cash.
5. Paid Tri-State Power Co. \$11,000 cash for energy usage in May.
6. Falske invested an additional \$29,000 in the business.

7. Paid Digital Equipment for the computers purchased in (1) above.
8. Incurred advertising expense for May of \$1,200 on account.

Instructions

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

- a. An increase in assets and a decrease in assets.
- b. An increase in assets and an increase in owner's equity.
- c. An increase in assets and an increase in liabilities.
- d. A decrease in assets and a decrease in owner's equity.
- e. A decrease in assets and a decrease in liabilities.
- f. An increase in liabilities and a decrease in owner's equity.
- g. An increase in owner's equity and a decrease in liabilities.

E1.8 (LO 4), AP Writing An analysis of the transactions made by Peat Deloitte & Co., a certified public accounting firm, for the month of August is shown as follows. The expenses were \$560 for rent, \$4,800 for salaries and wages, and \$400 for utilities.

Analyze transactions and compute net income.

	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital	-	Owner's Drawings	+	Revenues	-	Expenses
1.	+\$15,000										+\$15,000						
2.	-2,000						+\$5,000		+\$3,000								
3.	-750				+\$750												
4.	+4,000		+\$4,500												+\$8,500		
5.	-1,500								-1,500								
6.	-2,000												-\$2,000				
7.	-560																-\$560
8.	+450		-450														
9.	-4,800																-4,800
10.									+400								-400

Instructions

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

E1.9 (LO 5) Financial Statement An analysis of transactions for Peat DeLoitte & Co. a certified public accounting firm, for the month of August is shown as follows. The expenses were \$560 for rent, \$4,800 for salaries and wages, and \$400 for utilities.

Prepare financial statements.

	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital	-	Owner's Drawings	+	Revenues	-	Expenses
1.	+\$15,000										+\$15,000						
2.	-2,000						+\$5,000		+\$3,000								
3.	-750				+\$750												
4.	+4,000		+\$4,500												+\$8,500		
5.	-1,500								-1,500								
6.	-2,000												-\$2,000				
7.	-560																-\$560
8.	+450		-450														
9.	-4,800																-4,800
10.									+400								-400

Instructions

Prepare an income statement and an owner's equity statement for August and a balance sheet at August 31, 2022. Assume that August is the company's first month of business.

Determine net income (or loss).

E1.10 (LO 5), AP Hawke Company had the following assets and liabilities on the dates indicated.

<u>December 31</u>	<u>Total Assets</u>	<u>Total Liabilities</u>
2021	\$400,000	\$250,000
2022	\$460,000	\$300,000
2023	\$590,000	\$400,000

Hawke began business on January 1, 2021, with an investment of \$100,000.

Instructions

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

- 2021, assuming Hawke's drawings were \$12,000 for the year.
- 2022, assuming Hawke made an additional investment of \$34,000 and had no drawings in 2022.
- 2023, assuming Hawke made an additional investment of \$12,000 and had drawings of \$25,000 in 2023.

Analyze financial statements items.

E1.11 (LO 5), AN Two items are omitted from each of the following summaries of balance sheet and income statement data for two proprietorships for the year 2022, Greene's Goods and Solar Enterprises.

	<u>Greene's Goods</u>	<u>Solar Enterprises</u>
Beginning of year:		
Total assets	\$110,000	\$129,000
Total liabilities	85,000	(c)
Total owner's equity	(a)	80,000
End of year:		
Total assets	160,000	180,000
Total liabilities	120,000	50,000
Total owner's equity	40,000	130,000
Changes during year in owner's equity:		
Additional investment	(b)	25,000
Drawings	37,000	(d)
Total revenues	220,000	100,000
Total expenses	175,000	60,000

Instructions

Determine the missing amounts.

Prepare income statement and owner's equity statement.

E1.12 (LO 5), AP **Financial Statement** The following information relates to Fleete Co. for the year 2022.

Owner's capital, January 1, 2022	\$42,000	Advertising expense	\$ 1,800
Owner's drawings during 2022	6,000	Rent expense	10,400
Service revenue	63,600	Utilities expense	3,100
Salaries and wages expense	30,200		

Instructions

After analyzing the data, prepare an income statement and an owner's equity statement for the year ending December 31, 2022.

Correct an incorrectly prepared balance sheet.

E1.13 (LO 5), AN **Financial Statement** Abby Roland is the bookkeeper for Cheng Company. Abby has been trying to determine the correct balance sheet for Cheng Company, shown as follows.

<u>Cheng Company</u>			
<u>Balance Sheet</u>			
<u>December 31, 2022</u>			
<u>Assets</u>		<u>Liabilities</u>	
Cash	\$15,000	Accounts payable	\$21,000
Supplies	8,000	Accounts receivable	(6,500)
Equipment	46,000	Owner's capital	<u>67,500</u>
Owner's drawings	<u>13,000</u>	Total liabilities and	
Total assets	<u>\$82,000</u>	owner's equity	<u>\$82,000</u>

Instructions

Prepare a correct balance sheet.

E1.14 (LO 5), AP Financial Statement Saira Morrow is the sole owner of Buena Vista Park, a public camping ground near the Crater Lake National Recreation Area. Saira has compiled the following financial information as of December 31, 2022.

Compute net income and prepare a balance sheet.

Revenues during 2022—camping fees	\$140,000	Fair value of equipment	\$140,000
Revenues during 2022—general store	65,000	Notes payable	60,000
Accounts payable	11,000	Expenses during 2022	160,000
Cash on hand	23,000	Accounts receivable	17,500
Original cost of equipment	115,500		

Instructions

- Determine Saira Morrow's net income from Buena Vista Park for 2022.
- Prepare a balance sheet for Buena Vista Park as of December 31, 2022.

E1.15 (LO 5), AP Financial Statement The following financial information is related to the operations of Sea Legs Cruise Company for the year ended December 31, 2022.

Prepare an income statement.

Maintenance and repairs expense	\$ 95,000
Utilities expense	13,000
Salaries and wages expense	142,000
Advertising expense	24,500
Ticket revenue	410,000

Instructions

Prepare the 2022 income statement for Sea Legs Cruise Company.

E1.16 (LO 5), AP Financial Statement The following information is related to the sole proprietorship of Helen Archer, attorney.

Prepare an owner's equity statement.

Legal service revenue—2022	\$330,000
Total expenses—2022	211,000
Assets, January 1, 2022	98,000
Liabilities, January 1, 2022	62,000
Assets, December 31, 2022	168,000
Liabilities, December 31, 2022	100,000
Drawings—2022	?

Instructions

Prepare the 2022 owner's equity statement for Helen Archer's legal practice.

E1.17 (LO 5), AP Financial Statement This information is for Paulo Company for the year ended December 31, 2022.

Prepare a cash flow statement.

Cash received from revenues from customers	\$600,000
Cash received from investment by owner	280,000
Cash paid for new equipment	115,000
Cash drawings by owner paid	18,000
Cash paid for expenses	430,000
Cash balance 1/1/22	30,000

Instructions

Prepare the 2022 statement of cash flows for Paulo Company.

E1.18 (LO 5), C The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. Operating activities are the types of activities the company performs to generate profits. Investing activities include the purchase of long-lived assets such as equipment or the purchase of investment securities. Financing activities are borrowing money, investment by owner, and cash drawings by owner.

Identify cash flow activities.

Presented below are the following transactions.

- Owner invested \$20,000 cash.
- Issued note payable for \$12,000 cash.
- Purchased office equipment for \$11,000 cash.
- Received \$15,000 cash for services performed.

5. Paid \$1,000 cash for rent.
6. Paid \$600 cash drawings to owner.
7. Paid \$5,700 cash for salaries.

Instructions

Classify each of these transactions as operating, investing, or financing activities.

Problems

Analyze transactions and compute net income.



Excel templates for selected exercises and problems provide students a framework for solving in Excel.

Check figures provide a key number to let you know you are on the right track.

- a. Total assets \$20,800
- b. Net income \$6,200

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



- a. Total assets \$16,500
- b. Net income \$3,130
Ending capital \$11,230

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

P1.1 (LO 3, 4), AP On April 1, Julie Spengel established Spengel's Travel Agency. The following transactions were completed during the month.

1. Invested \$15,000 cash to start the agency.
2. Paid \$600 cash for April office rent.
3. Purchased equipment for \$3,000 cash.
4. Incurred \$700 of advertising costs in the *Chicago Tribune*, on account.
5. Paid \$900 cash for office supplies.
6. Performed services worth \$10,000; \$3,000 cash is received from customers, and the balance of \$7,000 is billed to customers on account.
7. Withdrew \$600 cash for personal use.
8. Paid *Chicago Tribune* \$500 of the amount due in transaction (4).
9. Paid employees' salaries \$2,500.
10. Received \$4,000 in cash from customers who have previously been billed in transaction (6).

Instructions

- a. Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Owner's Capital, Owner's Drawings, Revenues, and Expenses.
- b. From an analysis of the owner's equity columns, compute the net income or net loss for April.

P1.2 (LO 4, 5), AP Financial Statement Sonya Jared opened a law office on July 1, 2022. On July 31, the balance sheet showed Cash \$5,000, Accounts Receivable \$1,500, Supplies \$500, Equipment \$6,000, Accounts Payable \$4,200, and Owner's Capital \$8,800. During August, the following transactions occurred.

1. Collected \$1,200 of accounts receivable.
2. Paid \$2,800 cash on accounts payable.
3. Recognized revenue of \$7,500 of which \$4,000 is collected in cash and the balance is due in September.
4. Purchased additional equipment for \$2,000, paying \$400 in cash and the balance on account.
5. Paid salaries \$2,800, rent for August \$900, and advertising expenses \$400.
6. Withdrew \$700 in cash for personal use.
7. Received \$2,000 from Standard Federal Bank—money borrowed on a note payable.
8. Incurred utility expenses for month on account \$270.

Instructions

- a. Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Owner's Capital - Owner's Drawings + Revenues - Expenses.
- b. Prepare an income statement for August, an owner's equity statement for August, and a balance sheet at August 31.

P1.3 (LO 5), AP Financial Statement On June 1, Cindy Godfrey started Divine Designs Co., a company that provides craft opportunities, by investing \$12,000 cash in the business. Following are the assets and liabilities of the company at June 30 and the revenues and expenses for the month of June.

Cash	\$10,150	Service Revenue	\$6,500
Accounts Receivable	2,800	Advertising Expense	500
Supplies	2,000	Rent Expense	1,600
Equipment	10,000	Gasoline Expense	200
Notes Payable	9,000	Utilities Expense	150
Accounts Payable	1,200		

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

Instructions

- Prepare an income statement and owner's equity statement for the month of June and a balance sheet at June 30, 2022.
- Prepare an income statement and owner's equity statement for June assuming the following data are not included above: (1) \$900 of services were performed and billed but not collected at June 30, and (2) \$150 of gasoline expense was incurred but not paid.

- Net income \$4,050
Owner's equity \$14,750
Total assets \$24,950
- Owner's equity \$15,500

P1.4 (LO 4, 5), AP Financial Statement Maisie Taft started her own consulting firm, Maisie Consulting, on May 1, 2022. The following transactions occurred during the month of May.

Analyze transactions and prepare financial statements.

- May
- Maisie invested \$7,000 cash in the business.
 - Paid \$900 for office rent for the month.
 - Purchased \$800 of supplies on account.
 - Paid \$125 to advertise in the *County News*.
 - Received \$4,000 cash for services performed.
 - Withdrew \$1,000 cash for personal use.
 - Performed \$6,400 of services on account.
 - Paid \$2,500 for employee salaries.
 - Made a partial payment of \$600 for the supplies purchased on account on May 3.
 - Received a cash payment of \$4,000 for services performed on account on May 15.
 - Borrowed \$5,000 from the bank on a note payable.
 - Purchased equipment for \$4,200 on account.
 - Paid \$275 for utilities.

Instructions

- Show the effects of the previous transactions on the accounting equation using the following format.

Assets					Liabilities		Owner's Equity			
Date	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Payable	+ Accounts Payable	+ Owner's Capital	- Owner's Drawings	+ Revenues	- Expenses

- Prepare an income statement for the month of May.
- Prepare a balance sheet at May 31, 2022.

- Net income \$6,600
- Cash \$14,600

P1.5 (LO 4, 5), AP Writing Financial Statement Financial statement information about four different companies is as follows.

Determine financial statement amounts and prepare owner's equity statement.

	Alpha Company	Beta Company	Psi Company	Omega Company
January 1, 2022				
Assets	\$ 80,000	\$ 90,000	(g)	\$150,000
Liabilities	41,000	(d)	80,000	(j)
Owner's equity	(a)	40,000	49,000	90,000
December 31, 2022				
Assets	(b)	112,000	170,000	(k)
Liabilities	60,000	72,000	(h)	100,000
Owner's equity	50,000	(e)	82,000	151,000
Owner's equity changes in year				
Additional investment	(c)	8,000	10,000	15,000
Drawings	15,000	(f)	12,000	10,000
Total revenues	350,000	410,000	(i)	500,000
Total expenses	333,000	385,000	350,000	(l)

- a. (c) Additional investment
\$9,000
- (i) Total revenues \$385,000

Instructions

- Determine the missing amounts. (*Hint:* For example, to solve for (a), $\text{Assets} - \text{Liabilities} = \text{Owner's equity} = \$39,000$.)
- Prepare the owner's equity statement for Alpha Company.
- Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the owner's equity statement to the income statement and balance sheet.

Continuing Case

The **Cookie Creations** case starts in this chapter and continues through Chapter 18. The business begins as a sole proprietorship and then evolves into a partnership and finally a corporation. You also can find this case in WileyPLUS.

Cookie Creations

CC1 Natalie Koebel spent much of her childhood learning the art of cookie-making from her grandmother. They passed many happy hours mastering every type of cookie imaginable and later creating new recipes that were both healthy and delicious. Now at the start of her second year in college, Natalie is investigating various possibilities for starting her own business as part of the requirements of the entrepreneurship program in which she is enrolled.

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

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

Instructions

- What form of business organization—proprietorship, partnership, or corporation—do you recommend that Natalie use for her business? Discuss the benefits and weaknesses of each form and give the reasons for your choice.
- Will Natalie need accounting information? If yes, what information will she need and why? How often will she need this information?
- Identify specific asset, liability, and owner's equity accounts that Cookie Creations will likely use to record its business transactions.
- Should Natalie open a separate bank account for the business? Why or why not?



leungchopan/
Shutterstock.com

Ethics Case

EC1 After numerous campus interviews, Travis Chase, a senior at Great Northern College, received two office interview invitations from the Baltimore offices of two large firms. Both firms offered to cover his out-of-pocket expenses (travel, hotel, and meals). He scheduled the interviews for both firms on the same day, one in the morning and one in the afternoon. At the conclusion of each interview, he submitted to both firms his total out-of-pocket expenses for the trip to Baltimore: mileage \$112 (280 miles at \$0.40), hotel \$130, meals \$36, and parking and tolls \$18, for a total of \$296. He believes this approach is appropriate. If he had made two trips, his cost would have been two times \$296. He is also certain that neither firm knew he had visited the other on that same trip. Within 10 days, Travis received two checks in the mail, each in the amount of \$296.

Instructions

- Who are the stakeholders (affected parties) in this situation?
- What are the ethical issues in this case?
- What would you do in this situation?

Expand Your Critical Thinking

Financial Reporting Problem: Apple Inc.

CT1.1 The financial statements of **Apple Inc.** for 2019 are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

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

- What were Apple's total assets at September 28, 2019? At September 29, 2018?
- How much cash (and cash equivalents) did Apple have on September 28, 2019?
- What amount of accounts payable did Apple report on September 28, 2019? On September 29, 2018?
- What were Apple's net sales in 2017? In 2018? In 2019?
- What is the amount of the change in Apple's net income from 2018 to 2019?

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

CT1.2 **PepsiCo, Inc.**'s financial statements are presented in Appendix B. Financial statements of **The Coca-Cola Company** are presented in Appendix C. The complete annual reports of PepsiCo and Coca-Cola, including the notes to the financial statements, are available at each company's respective website.

Instructions

- Based on the information contained in these financial statements, determine the following for each company.
 - Total assets at December 28, 2019, for PepsiCo and for Coca-Cola at December 31, 2019.
 - Accounts (notes) receivable, net at December 28, 2019, for PepsiCo and at December 31, 2019, for Coca-Cola.
 - Net revenues for year ended in 2019.
 - Net income for year ended in 2019.
- What conclusions concerning the two companies can be drawn from these data?

Comparative Analysis Problem: Amazon.com, Inc. vs. Walmart Inc.

CT1.3 **Amazon.com, Inc.**'s financial statements are presented in Appendix D. Financial statements of **Walmart Inc.** are presented in Appendix E. The complete annual reports of Amazon and Walmart, including the notes to the financial statements, are available at each company's respective website.

Instructions

- Based on the information contained in these financial statements, determine the following for each company.
 - Total assets at December 31, 2019, for Amazon and for Walmart at January 31, 2020.
 - Receivables (net) at December 31, 2019, for Amazon and for Walmart at January 31, 2020.
 - Net sales (product only) for year ended in 2019 (2020 for Walmart).
 - Net income for the year ended in 2019 (2020 for Walmart).
- What conclusions concerning these two companies can be drawn from these data?

Real-World Focus

CT1.4 This exercise will familiarize you with the skills needed (other than accounting skills) to be a successful accountant.

Instructions

Search the Internet for "start here go places" to access free accounting resources for future CPAs and then answer the following questions.

- What are the four skill sets that are useful for success in accounting?
- Why are these skill sets useful for a successful accounting career?

Decision-Making Across the Organization

CT1.5 Anya and Nick Ramon, local golf stars, opened the Chip-Shot Driving Range on March 1, 2022, by investing \$25,000 of their cash savings in the business. A caddy shack was constructed for cash at a cost of \$8,000, and \$800 was spent on golf balls and golf clubs. The Ramons leased five acres of land at a cost of \$1,000 per month and paid the first month's rent. During the first month, advertising costs totaled \$750, of which \$100 was unpaid at March 31, and \$400 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, Anya and Nick withdrew a total of \$1,000 in cash for personal living expenses. A \$120 utility bill was received on March 31 but was not paid. On March 31, the balance in the company's bank account was \$18,900.

Anya and Nick thought they had a pretty good first month of operations. But, their estimates of profitability ranged from a loss of \$6,100 to net income of \$2,480.

Instructions

With the class divided into groups, answer the following.

- How could the Ramons have concluded that the business operated at a loss of \$6,100? Was this a valid basis on which to determine net income?
- How could the Ramons have concluded that the business operated at a net income of \$2,480? (*Hint:* Prepare a balance sheet at March 31.) Was this a valid basis on which to determine net income?
- Without preparing an income statement, determine the actual net income for March.
- What was the revenue recognized in March?

Communication Activity

CT1.6 Amy Sawyer, the bookkeeper for New Hampshire Company, has been trying to determine the correct balance sheet for the company. The company's balance sheet is shown as follows.

New Hampshire Company			
Balance Sheet			
For the Month Ended December 31, 2022			
Assets		Liabilities	
Equipment	\$25,500	Owner's capital	\$26,000
Cash	9,000	Accounts receivable	(5,000)
Supplies	3,000	Owner's drawings	(2,000)
Accounts payable	(8,000)	Notes payable	10,500
	<u>\$29,500</u>		<u>\$29,500</u>

Instructions

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

All About You

CT1.7 Some people are tempted to make their finances look worse to obtain financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity to being both unethical and illegal attempts to mislead investors and creditors.

Instructions

Provide responses for each of the following questions.

- Discuss whether you think each of the following actions (adapted from the FAFSA website) to increase the chances of receiving financial aid is ethical.
 - Spend the student's assets and income first, before spending parents' assets and income.
 - Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
 - State that a truly financially dependent child is independent.
 - Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.

- b. What are some reasons why a **company** might want to overstate its earnings?
- c. What are some reasons why a **company** might want to understate its earnings?
- d. Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

Considering People, Planet, and Profit

CT1.8 Although **Clif Bar & Company** is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts.

Instructions

Go to the Who We Are page at the Clif Bar website and identify the five aspirations.

FASB Codification Activity

CT1.9 The FASB has developed the Financial Accounting Standards Board Accounting Standards Codification (or more simply “the Codification”). The FASB’s primary goal in developing the Codification is to provide in one place all the authoritative literature related to a particular topic. To provide easy access to the Codification, the FASB also developed the Financial Accounting Standards Board Codification Research System (CRS). CRS is an online, real-time database that provides easy access to the Codification. The Codification and the related CRS provide a topically organized structure, subdivided into topic, subtopics, sections, and paragraphs, using a numerical index system.

You may find this system useful in your present and future studies, and so we have provided an opportunity to use this online system as part of the *Expand Your Critical Thinking* section.

Instructions

Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association, for an annual fee. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should log in and familiarize yourself with the resources that are accessible at the FASB Codification site.

Answers to Insight and Accounting Across the Organization Questions

Using Data Science to Create Art **Q:** How can “big data” improve decision-making? **A:** Companies analyze the large amounts of data now available to improve cost estimation for future projects as well as identify bottlenecks and opportunities to increase the efficiency of production processes.

I Felt the Pressure—Would You? **Q:** Why did these employees lie, and what do you believe should be their penalty for these lies? **A:** They felt pressured by their supervisors to make the company’s financial statements look better than warranted. They should be prosecuted for fraudulent activities under the Sarbanes-Oxley Act, as they knowingly misstated financial statement data.

The Korean Discount **Q:** What is meant by the phrase “make the country’s business more transparent”? Why would increasing transparency spur economic growth? **A:** Transparency refers to the extent to which outsiders have knowledge regarding a company’s financial performance and financial position. If a company lacks transparency, its financial reports do not adequately inform investors of critical information that is needed to make investment decisions. If corporate transparency is increased, investors would be more willing to supply the financial capital that businesses need in order to grow, which would spur the country’s economic growth.

Spinning the Career Wheel **Q:** How might accounting help you? **A:** You will need to understand financial reports in any enterprise with which you are associated. Whether you become a manager, a doctor, a lawyer, a social worker, a teacher, an engineer, an architect, or an entrepreneur, a working knowledge of accounting is relevant.

Beyond Financial Statements **Q:** Why might a company’s stockholders be interested in its environmental and social performance? **A:** Many companies now recognize that being a socially responsible organization is not only the right thing to do, but it also is good for business. Many investment professionals understand, for example, that environmental, social, and proper corporate governance of companies affects the performance of their investment portfolios. For example, **British Petroleum**’s oil spill disaster is a classic example of the problems that can occur for a company and its stockholders. BP’s stock price was slashed, its dividend reduced, its executives replaced, and its reputation badly damaged. It is interesting that socially responsible investment funds are now gaining momentum in the marketplace such that companies now recognize this segment as an important investment group.

A Look at IFRS

LEARNING OBJECTIVE 7

Describe the impact of international accounting standards on U.S. financial reporting.

Most agree that there is a need for one set of international accounting standards. Here is why:

Multinational corporations. Today's companies view the entire world as their market. For example, **Coca-Cola**, **Intel**, and **McDonald's** generate more than 50% of their sales outside the United States. Many foreign companies, such as **Toyota**, **Nestlé**, and **Sony**, find their largest market to be the United States.

Mergers and acquisitions. The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations of companies from different countries in the future.

Information technology. As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.

Financial markets. Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

Key Points

Following are the key similarities and differences between GAAP and IFRS as related to accounting fundamentals.

Similarities

- The basic techniques for recording business transactions are the same for U.S. and international companies.
- Both international and U. S. accounting standards emphasize transparency in financial reporting. Both sets of standards are primarily driven by meeting the needs of investors and creditors.
- The three most common forms of business organizations, proprietorships, partnerships, and corporations, are also found in countries that use international accounting standards.

Differences

- International standards are referred to as International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board. Accounting standards in the United States are referred to as generally accepted accounting principles (GAAP) and are developed by the Financial Accounting Standards Board.
- IFRS tends to be simpler in its accounting and disclosure requirements; some people say it is more "principles-based." GAAP is more detailed; some people say it is more "rules-based."
- The internal control standards applicable to Sarbanes-Oxley (SOX) apply only to large public companies listed on U.S. exchanges. There is continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation.

IFRS Practice

IFRS Self-Test Questions

1. Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?
 - a. Mergers and acquisition activity.
 - b. Financial markets.
 - c. Multinational corporations.
 - d. GAAP is widely considered to be a superior reporting system.
2. The Sarbanes-Oxley Act determines:
 - a. international tax regulations.
 - b. internal control standards as enforced by the IASB.
 - c. internal control standards of U.S. publicly traded companies.
 - d. U.S. tax regulations.
3. IFRS is considered to be more:
 - a. principles-based and less rules-based than GAAP.
 - b. rules-based and less principles-based than GAAP.
 - c. detailed than GAAP.
 - d. None of the answer choices is correct.

IFRS Exercises

IFRS1.1 Who are the two key international players in the development of international accounting standards? Explain their role.

IFRS1.2 What is the benefit of a single set of high-quality accounting standards?

International Financial Reporting Problem: Louis Vuitton

IFRS1.3 The financial statements of **Louis Vuitton** are presented in Appendix F. The complete consolidated statements, including the notes to its financial statements, are available at the company's website.

Instructions

Visit Louis Vuitton's corporate website and answer the following questions from the company's notes to its 2019 consolidated financial statements.

- a. What accounting firm performed the audit of Louis Vuitton's financial statements?
- b. What is the address of the company's corporate headquarters?
- c. What is the company's reporting currency?

Answers to IFRS Self-Test Questions

1. d 2. c 3. a

