

# Chapter 1

## Accounting in Action

### STUDY OBJECTIVES

After studying this chapter, you should be able to:

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



### The Navigator

Scan <b>Study Objectives</b>	■
Read <b>Feature Story</b>	■
Read <b>Preview</b>	■
Read text and answer <b>Do it!</b> p. 11 ■ p. 14 ■ p. 21 ■ p. 25 ■	
Work <b>Comprehensive Do it!</b> p. 27	■
Review <b>Summary of Study Objectives</b>	■
Answer <b>Self-Study Questions</b>	■
Complete <b>Assignments</b>	■

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

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

### Feature Story

#### KNOWING THE NUMBERS

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

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

When Jack Stack and 11 other managers purchased **Springfield ReManufacturing Corporation (SRC)** (USA) for 10 cents a share, it was failing. Stack had 119 employees who were counting on him for their livelihood, and he knew that the company was on the verge of financial failure.

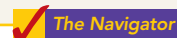


Stack decided that the company's only chance of survival was to encourage every employee to think like a businessperson and to act like an owner. To accomplish this, all employees at SRC took basic accounting courses and participated in weekly reviews of the company's financial statements. SRC survived,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

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

Taking this course will go a long way toward making you financially literate. In this book you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results. Appendices A and B provide real financial statements of two well-known companies, **Cadbury** (GBR) and **Nestlé** (CHE). Throughout this textbook, we attempt to increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements.

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



### Inside Chapter 1...

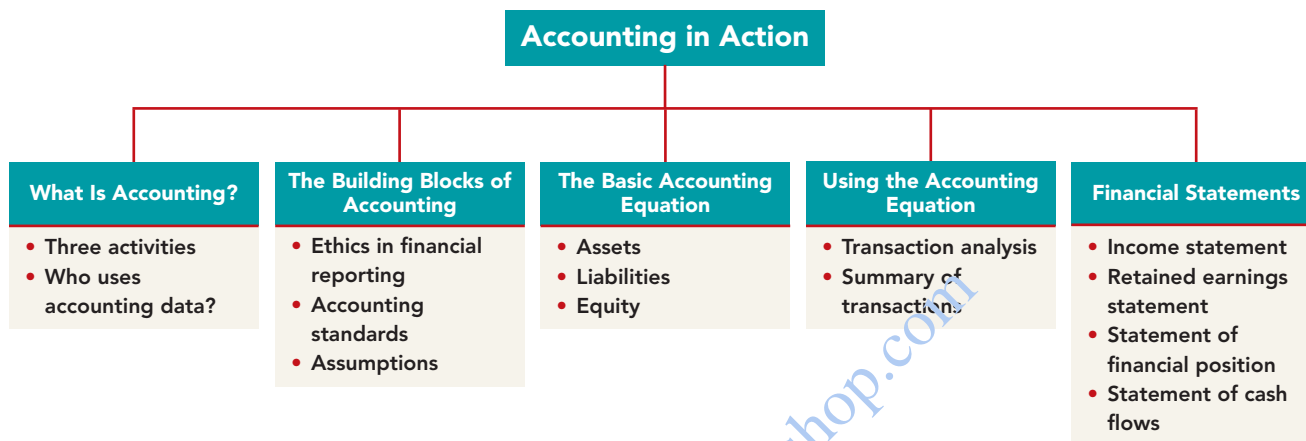
- **How Will Accounting Help Me?** (p. 11)
- **What Do Vodafone, Walt Disney, and JJB Sports Have in Common?** (p. 24)

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

## Preview of Chapter 1

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

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



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



## WHAT IS ACCOUNTING?

### STUDY OBJECTIVE 1

Explain what accounting is.

Why is accounting so popular? What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? Accounting.<sup>1</sup> Why did these people choose accounting? They wanted to acquire the skills needed to understand what was happening financially inside a company. Accounting is the financial information system that provides these insights. In short, to understand an organization of any type, you have to know the numbers.

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

### Three Activities

To **identify** economic events, a company selects the **economic events relevant to its business**. Examples of economic events are the sale of food and snacks by **Unilever** (GBR and NLD), providing of telephone services by **Chunghwa Telecom** (TWN), and the manufacture of motor vehicles by **Tata Motors** (IND).

Once a company like Unilever identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of

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

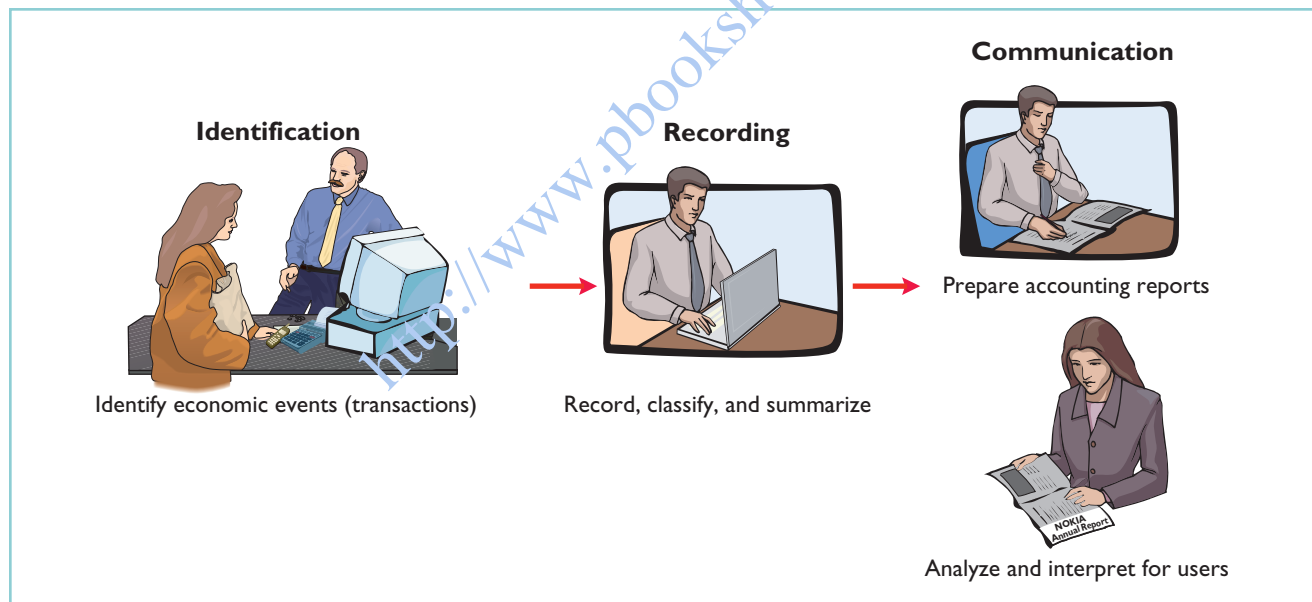
keeping a **systematic, chronological diary of events**, measured in dollars and cents. In recording, Unilever also classifies and summarizes economic events.

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

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

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

**Illustration 1-1**  
The activities of the accounting process



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

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

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

## Who Uses Accounting Data

### STUDY OBJECTIVE 2

Identify the users and uses of accounting.

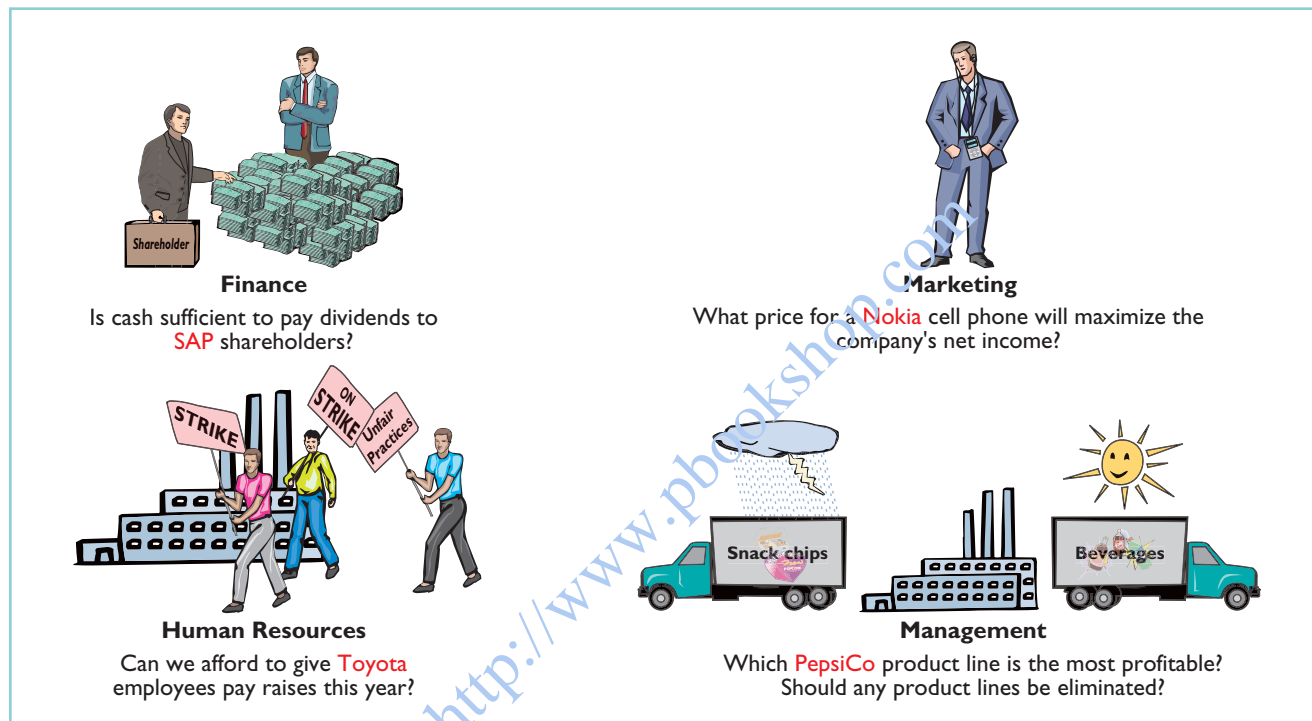
The information that a user of financial information needs depends upon the kinds of decisions the user makes. There are two broad groups of users of financial information: internal users and external users.

### INTERNAL USERS

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

#### Illustration 1-2

Questions asked by internal users

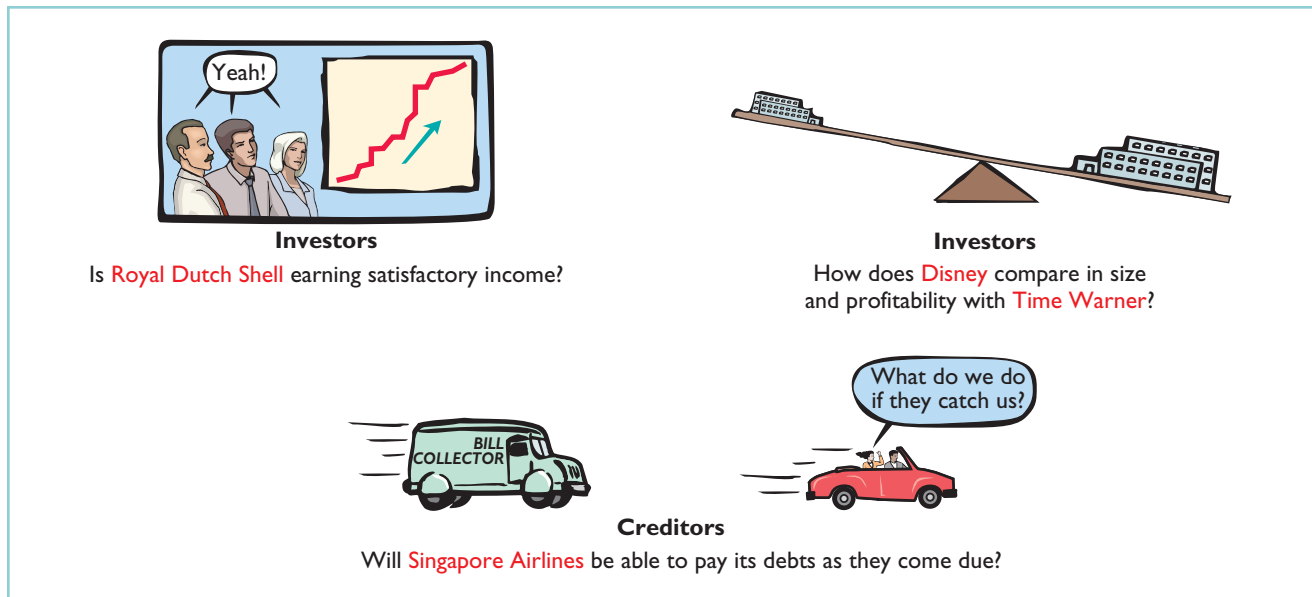


To answer these and other questions, internal users need detailed information on a timely basis. **Managerial accounting** provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns,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

### EXTERNAL USERS

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

**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 State Administration of Taxation in the People's Republic of China (CHN), want to



**Illustration 1-3**  
Questions asked by  
external users

know whether the company complies with tax laws. **Regulatory agencies**, such as the Autorité des Marchés Financiers (FRA) and the Federal Trade Commission (USA), want to know whether the company is operating within prescribed rules. **Customers** are interested in whether a company like **General Motors** (USA) will continue to honor product warranties and support its product lines. **Labor unions**, such as the German Confederation of Trade Unions (DEU), want to know whether the companies can pay increased wages and benefits to union members.

## THE BUILDING BLOCKS OF ACCOUNTING

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

### Ethics in Financial Reporting

People won't gamble in a casino if they think it is rigged. Similarly, people won't play the securities market if they think share prices are rigged. In recent years the financial press has been full of articles about financial scandals at **Enron** (USA), **Parmalat** (ITA), **Satyam Computer Services** (IND), **AIG** (USA), and others. As the scandals came to light, mistrust of financial reporting in general grew. One article in the financial press 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."<sup>3</sup> 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.

#### STUDY OBJECTIVE 3

Understand why ethics is a fundamental business concept.


<sup>3</sup>"U.S. Share Prices Slump," *Wall Street Journal* (February 21, 2002).

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

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

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

**Illustration 1-4**  
Steps in analyzing ethics cases and situations



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

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

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

## Accounting Standards

### STUDY OBJECTIVE 4

Explain accounting standards and the measurement principles.

In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard-setting bodies. Presently, there are two primary accounting standard-setting bodies—the **International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)**. More than 130 countries follow standards referred to as **International Financial Reporting Standards (IFRS)**. IFRSs are determined by the IASB. The IASB is headquartered in London, with its 15 board members drawn from around the world. Most companies in the United States follow standards issued by the FASB, referred to as **generally accepted accounting principles (GAAP)**.

As markets become more global, it is often desirable to compare the result of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies have made efforts to reduce the differences between IFRS and U.S. GAAP. This process is referred to as **convergence**. As a result of these convergence efforts, it is likely that someday there will be a single set of high-quality accounting standards that are used by companies around the world. Because convergence is such an important issue, we provide in each chapter of this textbook a summary page called *Understanding U.S. GAAP*, to provide a comparison with IFRS.

### MEASUREMENT PRINCIPLES

IFRS generally uses one of two measurement principles, the cost principle or the fair value principle. Selection of which principle to follow generally relates to

trade-offs between relevance and faithful representation. **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—it is factual.

**HELPFUL HINT**

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

*Helpful Hints further clarify concepts being discussed.*

**Cost Principle.** The **cost principle** (or historical cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if **Gazprom** (RUS) purchases land for py6300,000, the company initially reports it in its accounting records at py6300,000. But what does Gazprom do if, by the end of the next year, the fair value of the land has increased to py6400,000? Under the cost principle, it continues to report the land at py6300,000.

**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). 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 value 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, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to fair value, 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**.

**STUDY OBJECTIVE 5**

Explain the monetary unit assumption and the economic entity assumption.

**MONETARY UNIT ASSUMPTION**

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

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company’s owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money. Throughout this textbook, we use a variety of currencies in our examples and end-of-chapter materials. The currencies and the associated country or region are shown in Illustration 1-5.

Brazil, real	R\$	Russia, ruble	py6
China, yuan	¥	South Africa, rand	R
Europe, euro	€	South Korea, won	₩
Hong Kong, dollar	HK\$	Switzerland, Swiss franc	CHF
India, rupee	Rs	Turkey, lira	TL
Indonesia, rupiah	Rp	United Kingdom, pound	£
Japan, yen	¥	United States, dollar	\$

**Illustration 1-5**  
Currencies used in this textbook

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



#### ETHICS NOTE

The importance of the economic entity assumption is illustrated by scandals involving **Adelphia** (USA). 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.

### ECONOMIC ENTITY ASSUMPTION

**An economic entity can be any organization or unit in society.** It may be a company (such as **Telefónica** (ESP), a governmental unit (the city-state of Singapore), a municipality (Toronto, Canada), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the Boutique. Similarly, **Metro** (DEU), **Coca-Cola** (USA), and **Cadbury Schweppes** (GBR) 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.** 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 chartered public accountants).

**Corporation.** A business organized as a separate legal entity under corporation law and having ownership divided into transferable shares is a **corporation**. The holders of the shares (shareholders) **enjoy limited liability**; that is, they are not personally liable for the debts of the corporate entity. Shareholders **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 world significantly exceeds the number of corporations, the revenue produced by corporations is much greater. Most of the largest enterprises in the world—for example, **ING** (NLD), **Royal Dutch Shell** (GBR and NLD), **Wal-Mart** (USA), **Fortis** (BEL), and **Toyota** (JPN)—are corporations.

**Do it!**

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

1. The three steps in the accounting process are identification, recording, and communication.
2. The two most common types of external users are investors and company officers.
3. Shareholders in a corporation enjoy limited legal liability as compared to partners in a partnership.
4. The primary accounting standard-setting body outside the United States is the International Accounting Standards Board (IASB).
5. The cost principle dictates that companies record assets at their cost. In later periods, however, the fair value of the asset must be used if fair value is higher than its cost.

**Solution**

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

Related exercise material: **E1-1, E1-2, E1-3, E1-4**, and **Do it! 1-1**.

**before you go on...****Basic Concepts**

*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.*

**Action Plan**

- Review the basic concepts learned to date.
- Develop an understanding of the key terms used.

The Navigator

**ACCOUNTING ACROSS THE ORGANIZATION****How Will Accounting Help Me?**

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

**General management:** Imagine running Volkswagen (DEU), Massachusetts General Hospital (USA), a Subway (USA) franchise, a Fuji (JPN) bike shop. All general managers need to understand where the enterprise's cash comes from and where it goes in order to make wise business decisions.

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

**Finance:** Do you want to be a banker for Société Générale (FRA), or an investment analyst for Goldman Sachs (USA)? These fields rely heavily on accounting. In all of them you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

**Real estate:** Are you interested in being a real estate broker for Prudential Real Estate (USA)? 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?



How might accounting help you?



*Accounting Across the Organization boxes demonstrate applications of accounting information in various business functions. Guideline answers are provided on the last page of the chapter.*

## THE BASIC ACCOUNTING EQUATION

### STUDY OBJECTIVE 6

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **adidas** (DEU) has total assets of approximately €9.5 billion. Liabilities and owner's equity are the rights or claims against these resources. Thus, adidas has €9.5 billion of claims against its €9.5 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **equity**. Adidas has liabilities of €6.1 billion and equity of €3.4 billion.

We can express the relationship of assets, liabilities, and equity as an equation, as shown in Illustration 1-6.

#### Illustration 1-6

The basic accounting equation

Assets	=	Liabilities	+	Equity
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This relationship is the **basic accounting equation**. Assets must equal the sum of liabilities and equity.

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 **adidas**. The equation provides the **underlying framework** for recording and summarizing economic events.

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

### Assets

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

### Liabilities

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

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

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

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

## Equity

The ownership claim on total assets is **equity**. It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or shareholders. To find out what belongs to shareholders, we subtract creditors' claims (the liabilities) from the assets. The remainder is the shareholders' claim on the assets—equity. It is often referred to as **residual equity**—that is, the equity “left over” after creditors' claims are satisfied.

Equity generally consists of (1) share capital—ordinary and (2) retained earnings.

### SHARE CAPITAL—ORDINARY

A corporation may obtain funds by selling ordinary shares to investors. **Share capital—ordinary** is the term used to describe amounts paid in by shareholders for the ordinary shares they purchase.

### RETAINED EARNINGS

**Retained earnings** is determined by three items: revenues, expenses, and dividends.

**Revenues.** **Revenues are the gross increases in equity resulting from business activities entered into for the purpose of earning income.** Generally, revenues result from selling merchandise, performing services, renting property, and lending money.

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

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

**Dividends.** Net income represents an increase in net assets which are then available to distribute to shareholders. The distribution of cash or other assets to shareholders is called a **dividend**. Dividends reduce retained earnings. However, dividends are **not an expense**. A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income, and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the shareholders).

In summary, the principal sources (increases) of equity are investments by shareholders and revenues from business operations. In contrast, reductions (decreases) in equity result from expenses and dividends. These relationships are shown in Illustration 1-7 (page 14).

#### HELPFUL HINT

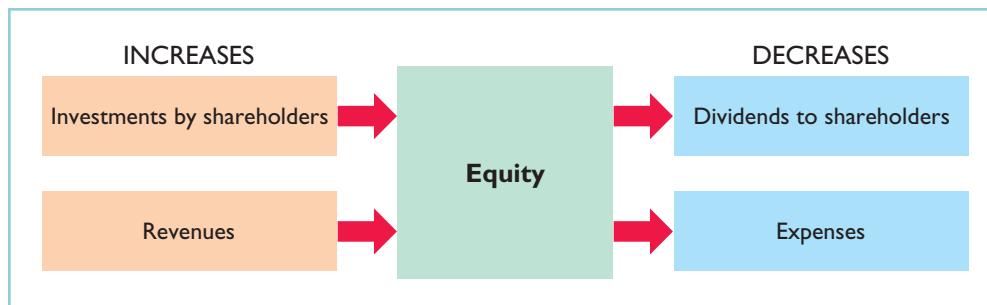
The effect of revenues is positive—an increase in equity coupled with an increase in assets or a decrease in liabilities.

#### HELPFUL HINT

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

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**Illustration 1-7**  
Increases and decreases in equity



before you go on...

**Equity Effects**

**Action Plan**

- Understand the sources of revenue.
- Understand what causes expenses.
- Review the rules for changes in equity:  
Investments and revenues increase equity. Expenses and dividends decrease equity.
- Recognize that dividends are distributions of cash or other assets to shareholders.

**Do it!**

Classify the following items as issuance of shares (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

- |                     |                      |
|---------------------|----------------------|
| (1) Rent Expense    | (3) Dividends        |
| (2) Service Revenue | (4) Salaries Expense |

**Solution**

1. Rent Expense is an expense (E); it decreases equity. 2. Service Revenue is a revenue (R); it increases equity. 3. Dividends is a distribution to shareholders (D); it decreases equity. 4. Salaries Expense is an expense (E); it decreases equity.

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

The Navigator

**USING THE ACCOUNTING EQUATION**

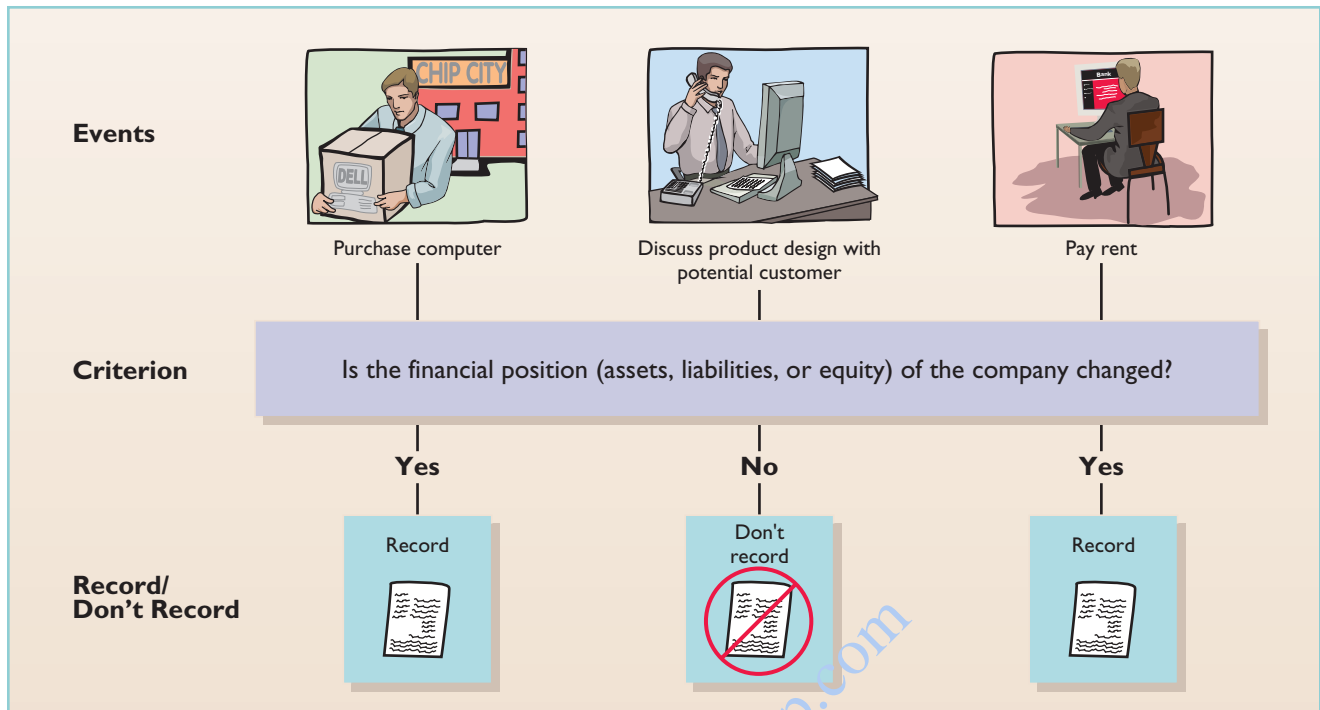
**STUDY OBJECTIVE 7**

Analyze the effects of business transactions on the accounting equation.

**Transactions (business transactions)** are a business's economic events recorded by accountants. Companies carry on many activities that do not represent business transactions. Examples are hiring employees, answering the telephone, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions: Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. Illustration 1-8 demonstrates the transaction-identification process.

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

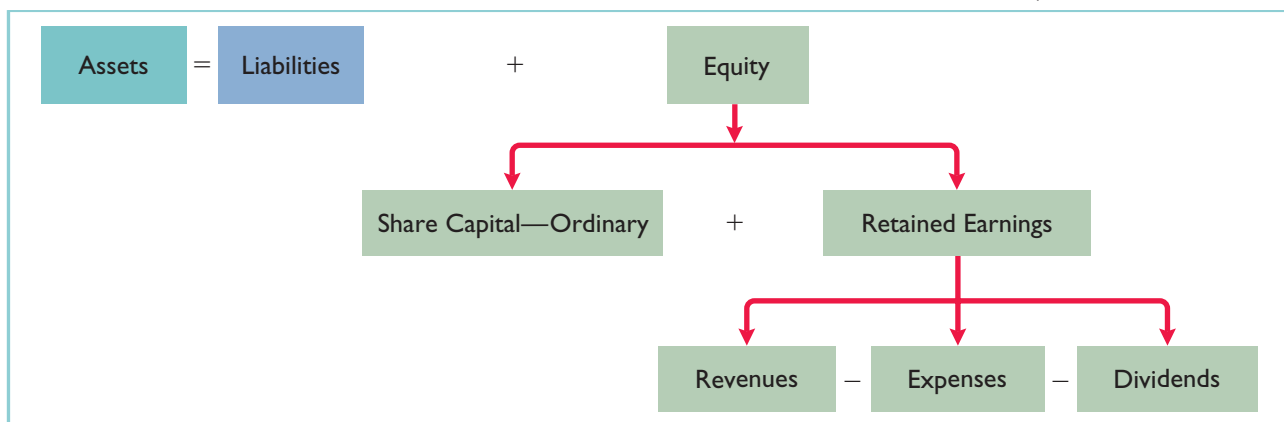


**Illustration 1-8**  
Transaction-identification process

### Transaction Analysis

In order to analyze transactions, we will examine a computer programming business (Softbyte Inc.) during its first month of operations. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on equity. Recall that equity is comprised of two parts: share capital—ordinary and retained earnings. Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash. Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends. Illustration 1-9 shows the expanded equation.

**Illustration 1-9**  
Expanded accounting equation



**HELPFUL HINT**

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

If you are tempted to skip ahead after you’ve read a few of the following transaction analyses, don’t do it. Each has something unique to teach, something you’ll need later. (We assure you that we’ve kept them to the minimum needed!)

**Transaction 1. Investment by Shareholders.** Ray and Barbara Neal decide to open a computer programming company that they incorporate as Softbyte Inc. On September 1, 2011, they invest \$15,000 cash in the business in exchange for \$15,000 of ordinary shares. The ordinary shares indicate the ownership interest that the Neals have in Softbyte Inc. This transaction results in an equal increase in both assets and equity. The asset Cash increases \$15,000, as does Share Capital—Ordinary. The effect of this transaction on the basic equation is:<sup>4</sup>

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>	
	Cash	=			Share Capital	
(1)	<b>+\$15,000</b>	=			<b>+\$15,000</b>	<b>Issued Shares</b>

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in equity (in this case, Issued Shares) is indicated. Why does this matter? Because investments by shareholders 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 (i.e., investments made by shareholders after the corporation has been initially formed) have the same effect on equity as the initial investment.

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

	<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Equity</u>	
	Cash	+ Equipment	=			Share Capital	
Old Bal.	\$15,000					\$15,000	
(2)	<b>-7,000</b>	<b>+7,000</b>					
New Bal.	<u>\$ 8,000</u>	<u>+ \$7,000</u>	=			\$15,000	
	\$15,000						

Observe that total assets are still \$15,000. Share Capital—Ordinary also remains at \$15,000, the amount of the original investment.

**Transaction 3. Purchase of Supplies on Credit.** Softbyte Inc. purchases for \$1,600 from Acme Supply Company computer paper and other supplies expected to last several months. Acme agrees to allow Softbyte to pay this bill in October.

<sup>4</sup>For the illustrative equations that follow, we use the general account title “Share Capital” instead of “Share Capital—Ordinary” for space considerations.

This transaction is a purchase on account (a credit purchase). Assets increase because of the expected future benefits of using the paper and supplies, and liabilities increase by the amount due Acme Company. The asset Supplies increases \$1,600, and the liability Accounts Payable increases by the same amount. The effect on the equation is:

	Assets			=	Liabilities	+	Equity
	Cash	Supplies	Equipment	=	Accounts Payable	+	Share Capital
Old Bal.	\$8,000		\$7,000	=			\$15,000
(3) New Bal.	\$8,000	<b>+\$1,600</b>	\$7,000	=	<b>+\$1,600</b>		\$15,000
	\$16,600				\$16,600		

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

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

	Assets			=	Liabilities	+	Equity				
	Cash	Supplies	Equipment	=	Accounts Payable	+	Share Capital	Retained Earnings			
				=		+	Rev.	Exp.	Div.		
Old Bal.	\$8,000	\$1,600	\$7,000	=	\$1,600	+	\$15,000				
(4) New Bal.	<b>+\$1,200</b>	\$1,600	\$7,000	=	\$1,600	+	\$15,000	<b>+\$1,200</b>			
	\$17,800				\$17,800						<b>Service Revenue</b>

The two sides of the equation balance at \$17,800. Note that equity increases when revenues are earned. The title Service Revenue indicates the source of the increase in equity. Service Revenue is included in determining Softbyte Inc.'s net income.

**Transaction 5. Purchase of Advertising on Credit.** Softbyte Inc. receives a bill for \$250 from the *Daily News* for advertising the opening of its business but postpones payment of the bill until a later date. This transaction results in an increase in liabilities and a decrease in equity. The specific items involved are Accounts Payable and Advertising Expense. The effect on the equation is:

	Assets			=	Liabilities	+	Equity				
	Cash	Supplies	Equipment	=	Accounts Payable	+	Share Capital	Retained Earnings			
				=		+	Rev.	Exp.	Div.		
Old Bal.	\$9,200	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$1,200			
(5) New Bal.	\$9,200	\$1,600	\$7,000	=	<b>+\$250</b>	+	\$15,000	\$1,200	<b>-\$250</b>		
	\$17,800				\$17,800						<b>Advertising Expense</b>

18 Chapter 1 Accounting in Action

The two sides of the equation still balance at \$17,800. Retained Earnings decreases when Softbyte incurs the expense. In addition, the specific cause of the decrease (advertising expense) is noted. Expenses do not have to be paid in cash at the time they are incurred. When 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.

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

	Assets				=	Liabilities	+	Equity										
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings		
													Rev.	-	Exp.	-	Div.	
Old Bal.	\$ 9,200					\$1,850		\$15,000					\$1,200		\$250			
(6)	<b>+1,500</b>		<b>+2,000</b>										<b>+3,500</b>					
New Bal.	\$10,700	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$250			
	\$21,300								\$21,300									<b>Service Revenue</b>

Why increase Service Revenue by \$3,500 when Softbyte has collected only \$1,500? We do so because the inflow of assets resulting from the earning of revenues does not have to be in the form of cash. Remember that equity increases when revenues are earned. Softbyte earns revenues when it provides the service. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

**Transaction 7. Payment of Expenses.** Softbyte pays the following expenses in cash for September: store rent \$600, salaries of employees \$900, and utilities \$200. These payments result in an equal decrease in assets and equity. Cash decreases \$1,700 and Retained Earnings decreases by the same amount. The effect of these payments on the equation is:

	Assets				=	Liabilities	+	Equity										
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings		
													Rev.	-	Exp.	-	Div.	
Old Bal.	\$10,700		\$2,000		\$1,600		\$7,000	=	\$1,850		\$15,000		\$4,700		\$250			
(7)	<b>-1,700</b>														<b>-600</b>			
															<b>-900</b>			
															<b>-200</b>			
New Bal.	\$ 9,000	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$4,700	-	\$1,950			
	\$19,600								\$19,600									<b>Rent Exp. Salaries Exp. Utilities Exp.</b>

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 Inc. pays its *Daily News* advertising bill of \$250 in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable and a decrease in Retained Earnings. This payment “on account” decreases the asset Cash by \$250 and also decreases the liability Accounts Payable by \$250. The effect of this transaction on the equation is:

	Assets				=	Liabilities	+	Equity									
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings	
Old Bal.	\$9,000		\$2,000		\$1,600		\$7,000	=	\$1,850		\$15,000		\$4,700		\$1,950		
(8)	-250							=	-250								
New Bal.	\$8,750	+	\$2,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950		
	\$19,350								\$19,350								

Observe that the payment of a liability related to an expense that has previously been recorded does not affect equity. Softbyte recorded the expense (in Transaction 5) and should not record it again. Neither Share Capital—Ordinary nor Retained Earnings changes as a result of this transaction.

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

	Assets				=	Liabilities	+	Equity									
	Cash	+	Accounts Receivable	+				Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings	
Old Bal.	\$8,750		\$2,000		\$1,600		\$7,000	=	\$1,600		\$15,000		\$4,700		\$1,950		
(9)	+600		-600					=									
New Bal.	\$9,350	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$4,700	-	\$1,950		
	\$19,350								\$19,350								

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

**Transaction 10. Dividends.** The corporation pays a dividend of \$1,300 in cash to Ray and Barbara Neal, the shareholders of Softbyte Inc. This transaction results in an equal decrease in assets and equity. Both Cash and Retained Earnings decrease \$1,300, as shown on the next page.

	Assets				=	Liabilities	+	Equity			
	Cash	Accounts Receivable	Supplies	Equipment				Accounts Payable	Share Capital	Retained Earnings	
								Rev.	Exp.	Div.	
Old Bal.	\$9,350	\$1,400	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$4,700	\$1,950	
(10)	-1,300				=						-1,300 Dividends
New Bal.	\$8,050	\$1,400	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$4,700	\$1,950	\$1,300
	\$18,050					\$18,050					

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

### Summary of Transactions

Illustration 1-10 summarizes the September transactions of Softbyte Inc. to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction.

**Illustration 1-10**  
Tabular summary of  
Softbyte Inc. transactions

Transaction	Assets				=	Liabilities	+	Equity			
	Cash	Accounts Receivable	Supplies	Equipment				Accounts Payable	Share Capital	Retained Earnings	
								Rev.	Exp.	Div.	
(1)	+\$15,000						+	\$15,000			Issued Shares
(2)	-7,000			+\$7,000							
(3)			+\$1,600		+\$1,600						
(4)	+1,200							+1,200			Service Revenue
(5)					+250				-\$250		Advert. Expense
(6)	+1,500	+\$2,000						+3,500			Service Revenue
(7)	-1,700								-600		Rent Expense
									-900		Salaries Expense
									-200		Utilities Expense
(8)	-250				-250						
(9)	+600	-600									
(10)	-1,300										-1,300 Dividends
	\$ 8,050	\$ 1,400	\$ 1,600	\$ 7,000	=	\$ 1,600	+	\$ 15,000	\$ 4,700	\$ 1,950	\$ 1,300
	\$18,050					\$18,050					

Illustration 1-10 demonstrates a number of significant facts:

- Each transaction must be analyzed in terms of its effect on:
  - the three components of the basic accounting equation.
  - specific types (kinds) of items within each component.
- The two sides of the equation must always be equal.
- The Share Capital—Ordinary and Retained Earnings columns indicate the causes of each change in the shareholders' claim on assets.

There! You made it through 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.

before you go on...

**Do it!**

Transactions made by Virmari & Co., a public accounting firm in France, 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 1-10.

1. The company issued ordinary shares for €25,000 cash.
2. The company purchased €7,000 of office equipment on credit.
3. The company received €8,000 cash in exchange for services performed.
4. The company paid €850 for this month's rent.
5. The company paid a dividend of €1,000 in cash to shareholders.

**Tabular Analysis**

**Action Plan**

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

**Solution**

Transaction	Assets		=	Liabilities	+	Equity			
	Cash	+ Office Equipment	=	Accounts Payable	+	Share Capital	Retained Earnings		
							Rev.	- Exp.	- Div.
(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>€8,000</u>	- <u>€850</u>	- <u>€1,000</u>	
	€38,150			€38,150					

Service Revenue  
Rent Expense  
Dividends

Related exercise material: BE1-6, BE1-7, BE1-8, BE1-9, E1-6, E1-7, E1-8, and Do it! 1-3.



**FINANCIAL STATEMENTS**

Companies prepare four financial statements from the summarized accounting data:

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

**STUDY OBJECTIVE 8**

Understand the four financial statements and how they are prepared.

Each statement provides relevant financial data for internal and external users.

Illustration 1-11 (page 22) shows the financial statements of Softbyte Inc. Note that the statements are interrelated:

1. Net income of \$2,750 shown on the income statement is added to the beginning balance of retained earnings in the retained earnings statement.
2. Retained earnings of \$1,450 at the end of the reporting period shown in the retained earnings statement is reported on the statement of financial position.
3. Cash of \$8,050 on the statement of financial position is reported on the statement of cash flows.

**HELPFUL HINT**

The income statement, retained earnings statement, and statement of cash flows are all for a *period* of time. The statement of financial position is for a *point* in time.

**Illustration 1-11**  
Financial statements and their interrelationships

**HELPFUL HINT**

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

**HELPFUL HINT**

The four financial statements are prepared in the sequence shown, for the following reasons:

- Net income is computed first and is needed to determine the ending balance in retained earnings.
- The ending balance in retained earnings is needed in preparing the statement of financial position.
- The cash shown on the statement of financial position is needed in preparing the statement of cash flows.

**HELPFUL HINT**

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

SOFTBYTE INC.		
Income Statement For the Month Ended September 30, 2011		
Revenues		
Service revenue		\$4,700
Expenses		
Salaries expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		1,950
Net income		<u><u>\$2,750</u></u>
SOFTBYTE INC.		
Retained Earnings Statement For the Month Ended September 30, 2011		
Retained earnings, September 1		\$ 0
Add: Net income		<u>2,750</u>
		2,750
Less: Dividends		<u>1,300</u>
Retained earnings, September 30		<u><u>\$1,450</u></u>
SOFTBYTE INC.		
Statement of Financial Position September 30, 2011		
<u>Assets</u>		
Equipment		\$ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		<u>8,050</u>
Total assets		<u><u>\$18,050</u></u>
<u>Equity and Liabilities</u>		
Equity		
Share capital—ordinary	\$15,000	
Retained earnings	<u>1,450</u>	<u>16,450</u>
Liabilities		
Accounts payable		1,600
Total equity and liabilities		<u><u>\$18,050</u></u>
SOFTBYTE INC.		
Statement of Cash Flows For the Month Ended September 30, 2011		
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		(7,000)
Cash flows from financing activities		
Sale of ordinary shares	\$15,000	
Payment of cash dividends	<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><u>\$ 8,050</u></u>

3

1

2

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

Be sure to carefully examine the format and content of each statement in Illustration 1-11. We describe the essential features of each in the following sections.

## Income Statement

The income statement reports the success or profitability of the company's operations over a specific period of time. For example, Softbyte Inc.'s income statement is dated "For the Month Ended September 30, 2011." It is prepared from the data appearing in the revenue and expense columns of Illustration 1-10 (page 20). 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 to list expenses in order of magnitude in our illustrations and homework solutions. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does not include investment and dividend transactions between the shareholders and the business in measuring net income. For example, as explained earlier, the cash dividend from Softbyte Inc. was not regarded as a business expense. This type of transaction is considered a reduction of retained earnings, which causes a decrease in equity.

## Retained Earnings Statement

Softbyte Inc.'s retained earnings statement reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2011"). Data for the preparation of the retained earnings statement come from the retained earnings columns of the tabular summary (Illustration 1-10) and from the income statement (Illustration 1-11).

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

## Statement of Financial Position

Softbyte Inc.'s statement of financial position reports the assets, liabilities, and equity at a specific date (September 30, 2011). The company prepares the statement of financial position from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1-10).

Observe that the statement of financial position lists assets at the top, followed by equity and then liabilities. Total assets must equal total equity and liabilities. Softbyte Inc. reports only one liability, accounts payable, on its statement of financial position. 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 (page 24).

### HELPFUL HINT

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

### ALTERNATIVE TERMINOLOGY

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

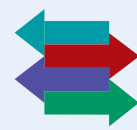
*Alternative Terminology notes present synonymous terms that you may come across in practice.*

**Illustration 1-12**  
Presentation of liabilities

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

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

## ACCOUNTING ACROSS THE ORGANIZATION



### What Do Vodafone, Walt Disney, and JJB Sports Have in Common?

Not every company uses December 31 as the accounting year-end. Some companies whose year-ends differ from December 31 are **Vodafone Group** (GBR), March 31; **Walt Disney Productions** (USA), September 30; and **JJB Sports** (GBR), the Sunday that falls before, but closest to, January 31. Why do companies choose the particular year-ends that they do? Many choose to end the accounting year when inventory or operations are at a low. Compiling accounting information requires much time and effort by managers, so companies would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low.



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

### HELPFUL HINT

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

## Statement of Cash Flows

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

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?

As shown in Softbyte Inc.'s statement of cash flows in Illustration 1-11, cash increased \$8,050 during the period. Net cash flow provided from operating activities increased cash \$1,350. Cash flow from investing transactions decreased cash \$7,000. And cash flow from financing transactions increased cash \$13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 13 will examine in detail how the statement is prepared.

before you go on...

**Do it!**

Presented below is selected information related to Flanagan Company at December 31, 2011. Flanagan reports financial information monthly.

**Financial Statement Items**

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

- (a) Determine the total assets of Flanagan Company at December 31, 2011.  
 (b) Determine the net income that Flanagan Company reported for December 2011.  
 (c) Determine the equity of Flanagan Company at December 31, 2011.

**Solution**

- (a) The total assets are £27,000, comprised of Office Equipment £10,000, Accounts Receivable £9,000, and Cash £8,000.  
 (b) Net income is £14,000, computed as follows:

Revenues		
Service revenue		£36,000
Expenses		
Rent expense	£11,000	
Wages expense	7,000	
Utilities expense	<u>4,000</u>	
Total expenses		<u>22,000</u>
Net income		<u>£14,000</u>

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

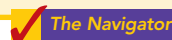
Total assets [as computed in (a)]		£27,000
Less: Liabilities		
Notes payable	£16,500	
Accounts payable	<u>2,000</u>	<u>18,500</u>
Equity		<u>£ 8,500</u>

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

**Action Plan**

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

Related exercise material: **BE1-10, BE1-11, E1-8, E1-10, E1-11**, and **Do it! 1-4**.



You will want to read  
 Understanding U.S. GAAP  
 on page 26

For discussion of how  
 international convergence efforts  
 relate to accounting standards.

## Understanding U.S. GAAP

# Accounting in Action

As indicated in the chapter, IFRSs, which are issued by the IASB, are used by most countries in the world. However, another major standard-setter resides in the United States: the Financial Accounting Standards Board (FASB). Prior to the creation of IFRS, the U.S. accounting standards, referred to as *generally accepted accounting principles (GAAP)*, were used by companies in many countries. Today, the IASB and the FASB are working jointly to achieve a single set of standards, although it may be five to ten years before a conversion to a single set of standards takes place. Until this happens, it is important for investors, accountants, and students to understand the key differences that exist between the standards.

### Key Differences

- In 2002, the U.S. Congress issued the Sarbanes-Oxley Act (SOX), which mandated certain internal controls for large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation. Debate about international companies (non-U.S.) adopting SOX-type standards centers on whether the benefits exceed the costs. The concern is that the higher costs of SOX compliance are making the U.S. securities markets less competitive.
- Financial frauds have occurred at companies such as **Satyam Computer Services (IND)**, **Parmalat (ITA)**, and **Royal Ahold (NLD)**. They have also occurred at large U.S. companies such as **Enron, WorldCom, and AIG**.
- IFRS tends to be less detailed in its accounting and disclosure requirements than GAAP. This difference in approach has resulted in a debate about the merits of “principles-based” (IFRS) versus “rules-based” (GAAP) standards.
- U.S. regulators have recently eliminated the need for foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP.
- GAAP is based on a conceptual framework that is similar to that used to develop IFRS.
- The three common forms of business organization that are presented in the chapter, proprietorships, partnerships, and corporations, are also found in the United States. Because the choice of business organization is influenced by factors such as legal environment, tax rates and regulations, and degree of entrepreneurship, the relative use of each form will vary across countries.
- Transaction analysis is basically the same under IFRS and GAAP but, as you will see in later chapters, the different standards may impact how transactions are recorded.

### Case in Point

The basic definitions provided in this textbook for the key elements of financial statements, that is, assets, liabilities, equity, revenues (revenues is sometimes referred to as income under IFRS), and expenses, are simplified versions of the official definitions provided by the IASB. Compare these definitions with those based on the FASB definitional structure provided below.

**Assets** Probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

**Liabilities** Probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

**Equity** The residual interest in the assets of an entity that remains after deducting its liabilities.

**Revenue** Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations.

**Expenses** Outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity’s ongoing major or central operations.

### Looking to the Future

Both the IASB and the FASB are hard at work developing standards that will lead to the elimination of major differences in the way certain transactions are accounted for and reported. Consider, for example, that as a result of a joint project on the conceptual framework, the definitions of the most fundamental elements (assets, liabilities, equity, revenues, and expenses) may actually change. However, whether the IASB adopts internal control provisions similar to those in SOX remains to be seen.



## Comprehensive Do it!

Legal Services Company was incorporated on July 1, 2011. During the first month of operations, the following transactions occurred.

1. Shareholders invested \$10,000 in cash in exchange for ordinary shares of Legal Services Company.
2. Paid \$800 for July rent on office space.
3. Purchased office equipment on account \$3,000.
4. Provided legal services to clients for cash \$1,500.
5. Borrowed \$700 cash from a bank on a note payable.
6. Performed legal services for client on account \$2,000.
7. Paid monthly expenses: salaries \$500, utilities \$300, and telephone \$100.

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

### Instructions

- (a) Prepare a tabular summary of the transactions.
- (b) Prepare the income statement, retained earnings statement, and statement of financial position at July 31 for Legal Services Inc.

### Solution to Comprehensive Do it!

(a) Trans- action	Assets			=	Liabilities		+	Equity				
	Cash	Accounts Receivable	Equipment	Note Payable	Accounts Payable	Share Capital		Retained Earnings				
								Rev.	Exp.	Div.		
(1)	+\$10,000					-\$10,000					Issued Shares	
(2)	-800								-800		Rent Expense	
(3)			+\$3,000		+\$3,000							
(4)	+1,500							+1,500			Service Revenue	
(5)	+700			+\$700								
(6)		+\$2,000						+2,000			Service Revenue	
(7)	-500								-500		Salaries Expense	
	-300								-300		Utilities Expense	
	-100								-100		Telephone Expense	
	<u>\$10,500</u>	<u>\$2,000</u>	<u>\$3,000</u>	<u>\$700</u>	<u>\$3,000</u>	<u>\$10,000</u>		<u>\$3,500</u>		<u>\$1,700</u>		
	\$15,500								\$15,500			

(b)

LEGAL SERVICES COMPANY		
INCOME STATEMENT		
For the Month Ended July 31, 2011		
Revenues		
Service revenue		\$3,500
Expenses		
Rent expense	\$800	
Salaries expense	500	
Utilities expense	300	
Telephone expense	<u>100</u>	
Total expenses		<u>1,700</u>
Net income		<u>\$1,800</u>

### Action Plan

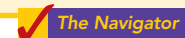
- Make sure that assets equal liabilities plus equity after each transaction.
- Investments and revenues increase equity. Dividends and expenses decrease equity.
- Prepare the financial statements in the order listed.
- The income statement shows revenues and expenses for a period of time.
- The retained earnings statement shows the changes in retained earnings for the same period of time as the income statement.
- The statement of financial position reports assets, liabilities, and equity at a specific date.

**LEGAL SERVICES COMPANY**  
**RETAINED EARNINGS STATEMENT**  
 For the Month Ended July 31, 2011

Retained earnings, July 1	\$ -0-
Add: Net income	<u>1,800</u>
Retained earnings, July 31	<u><u>\$1,800</u></u>

**LEGAL SERVICES COMPANY**  
**STATEMENT OF FINANCIAL POSITION**  
 July 31, 2011

<u>Assets</u>		
Equipment		\$ 3,000
Accounts receivable		2,000
Cash		<u>10,500</u>
Total assets		<u><u>\$15,500</u></u>
<u>Equity and Liabilities</u>		
Equity		
Share capital—ordinary	\$10,000	
Retained earnings	<u>1,800</u>	11,800
Liabilities		
Notes payable	700	
Accounts payable	<u>3,000</u>	<u>3,700</u>
Total equity and liabilities		<u><u>\$15,500</u></u>



## SUMMARY OF STUDY OBJECTIVES



- 1 **Explain what accounting is.** Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users.
- 2 **Identify the users and uses of accounting.** The major users and uses of accounting are as follows: (a) Management uses accounting information in planning, controlling, and evaluating business operations. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, labor unions, and economic planners.
- 3 **Understand why ethics is a fundamental business concept.** Ethics are the standards of conduct by which actions are judged as right or wrong. If you cannot depend on the honesty of the individuals you deal with, effective communication and economic activity would be impossible, and information would have no credibility.
- 4 **Explain accounting standards and the measurement principles.** Accounting is based on standards, such as International Financial Reporting Standards (IFRS). IFRS generally uses one of two measurement principles, the cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation.
- 5 **Explain the monetary unit assumption and the economic entity assumption.** The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner and other economic entities.

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

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

Assets are resources owned by a business. Liabilities are creditors' claims on total assets. Equity is the ownership claim on total assets.

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

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



## GLOSSARY



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

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

**Basic accounting equation**  $\text{Assets} = \text{Liabilities} + \text{Equity}$ . (p. 12).

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

**Convergence** The process of reducing the difference between IFRS and GAAP. (p. 8).

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

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

**Dividend** A distribution of cash or other assets by a corporation to its shareholders. (p. 13).

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

**Equity** The ownership claim on a corporation's total assets. (p. 13).

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

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

**Fair value principle** An accounting principle that states that companies should record assets at their fair value. (p. 9).

**Faithful representation** The numbers and descriptions of financial information match what really existed or happened—it is factual. (p. 9).

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

**Financial Accounting Standards Board (FASB)** An organization that establishes U.S. generally accepted accounting principles (GAAP). (p. 8).

**Generally accepted accounting principles (GAAP)** Accounting standards issued in the United States by the Financial Accounting Standards Board. (p. 8).

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

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

**International Financial Reporting Standards (IFRS)** Accounting standards issued by the International Accounting Standards Board. (p. 8).

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

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

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

**Net income** The amount by which revenues exceed expenses. (p. 23).

**Net loss** The amount by which expenses exceed revenues. (p. 23).

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

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

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

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

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

**Share capital—ordinary** Amounts paid in by shareholders for the ordinary shares they purchase. (p. 13).

**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. 21).

**Statement of financial position (balance sheet)** A financial statement that reports the assets, liabilities, and equity at a specific date. (p. 21).

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

## APPENDIX Accounting Career Opportunities

### STUDY OBJECTIVE 9

Explain the career opportunities in accounting.

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

Accounting is also hot because it is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by accounting failures and the turmoil over toxic assets at many financial institutions. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society. Finally, recent internal control requirements dramatically increased demand for professionals with accounting training.

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, an independent accountant, such as a chartered accountant (CA) or 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 CAs and 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.

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

Many accountants 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** (USA), **Nokia** (FIN), or **Samsung** (KOR). In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting

information system design and support, or tax planning and preparation. You might also be a member of your company's internal audit team. In response to corporate failures, 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 **International Red Cross** (CHE) or the **Bill and Melinda Gates Foundation** (USA).

## Opportunities in Government

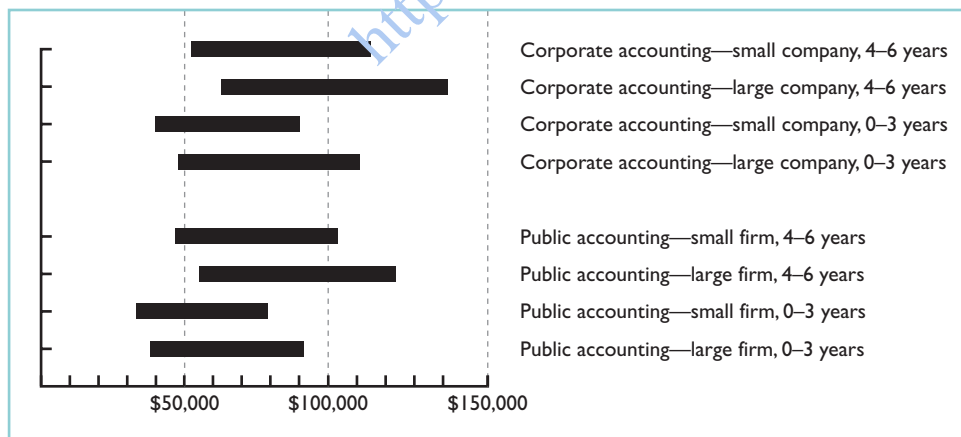
Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, tax authorities, law enforcement agencies, and corporate regulators all employ accountants. There is also a very high demand for accounting educators at colleges and universities and in government.

## 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 theft and fraud occurring at companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect insurance frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.

## "Show Me the Money"

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



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

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

For up-to-date salary estimates, as well as a wealth of additional information regarding accounting as a career, check out [www.startheregoplaces.com](http://www.startheregoplaces.com).

## SUMMARY OF STUDY OBJECTIVE FOR APPENDIX

### 9 Explain the career opportunities in accounting.

Accounting offers many different jobs in fields such as public and private accounting, government, and forensic

accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

## GLOSSARY FOR APPENDIX

**Auditing** The examination of financial statements by an independent accountant in order to express an opinion as to the fairness of presentation. (p. 30).

**Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 31).

**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. 30).

**Private (or managerial) accounting** An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation. (p. 30).

**Public accounting** An area of accounting in which the accountant offers expert service to the general public. (p. 30).

**Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 30).

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

## SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

- (SO 1) 1. Which of the following is *not* a step in the accounting process?
- a. Identification.                      c. Recording.  
b. Verification.                        d. Communication.
- (SO 2) 2. Which of the following statements about users of accounting information is *incorrect*?
- a. Management is an internal user.  
b. Taxing authorities are external users.  
c. Present creditors are external users.  
d. Regulatory authorities are internal users.
- (SO 4) 3. The cost principle states that:
- a. assets should be initially recorded at cost and adjusted when the market value changes.  
b. activities of an entity are to be kept separate and distinct from its owner.  
c. assets should be recorded at their cost.  
d. only transaction data capable of being expressed in terms of money be included in the accounting records.
- (SO 5) 4. Which of the following statements about basic assumptions is *correct*?
- a. Basic assumptions are the same as accounting principles.  
b. The economic entity assumption states that there should be a particular unit of accountability.  
c. The monetary unit assumption enables accounting to measure employee morale.  
d. Partnerships are not economic entities.
- (SO 5) 5. The three types of business entities are:
- a. proprietorships, small businesses, and partnerships.  
b. proprietorships, partnerships, and corporations.  
c. proprietorships, partnerships, and large businesses.  
d. financial, manufacturing, and service companies.
6. Net income will result during a time period when:
- a. assets exceed liabilities.  
b. assets exceed revenues.  
c. expenses exceed revenues.  
d. revenues exceed expenses.
7. Performing services on account will have the following effects on the components of the basic accounting equation:
- a. increase assets and decrease equity.  
b. increase assets and increase equity.  
c. increase assets and increase liabilities.  
d. increase liabilities and increase equity.
8. As of December 31, 2011, Stoneland Company has assets of €3,500 and equity of €2,000. What are the liabilities for Stoneland Company as of December 31, 2011?
- a. €1,500.    b. €1,000.    c. €2,500.    d. €2,000.
9. Which of the following events is *not* recorded in the accounting records?
- a. Equipment is purchased on account.  
b. An employee is terminated.  
c. A cash investment is made into the business.  
d. The company pays a cash dividend.
10. During 2011, Gibson Company's assets decreased \$50,000 and its liabilities decreased \$90,000. Its equity therefore:
- a. increased \$40,000.  
b. decreased \$140,000.  
c. decreased \$40,000.  
d. increased \$140,000.



- (SO 7) 11. Payment of an account payable affects the components of the accounting equation in the following way.
- Decreases equity and decreases liabilities.
  - Increases assets and decreases liabilities.
  - Decreases assets and increases equity.
  - Decreases assets and decreases liabilities.
- (SO 8) 12. 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 statement of financial position reports the assets, liabilities, and equity at a specific date.
  - An income statement presents the revenues, expenses, changes in equity, and resulting net income or net loss for a specific period of time.
  - A retained earnings statement summarizes the changes in retained earnings for a specific period of time.
- (SO 8) 13. On the last day of the period, Jim Otto Company buys a \$900 machine on credit. This transaction will affect the:
- income statement only.
  - statement of financial position only.
  - income statement and retained earnings statement only.
  - income statement, retained earnings statement, and statement of financial position.
14. The financial statement that reports assets, liabilities, and equity is the:
- income statement.
  - retained earnings statement.
  - statement of financial position.
  - statement of cash flow.
- \*15. Services provided by a public accountant include:
- auditing, taxation, and management consulting.
  - auditing, budgeting, and management consulting.
  - auditing, budgeting, and cost accounting.
  - internal auditing, budgeting, and management consulting.

Go to the book's companion website, [www.wiley.com/college/weygandtfrs](http://www.wiley.com/college/weygandtfrs), for Additional Self-Study Questions.



## QUESTIONS

- "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.
- Identify and describe the steps 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." Do you agree? Explain.
- Karen Sommers Travel Agency purchased land for \$90,000 cash on December 10, 2011. At December 31, 2011, the land's value has increased to \$93,000. What amount should be reported for land on the statement of financial position at December 31, 2011? Explain.
- What is the definition of the fair value principle?
- 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?
- Maria Gonzalez is the owner of a successful printing shop. Recently her business has been increasing, and Maria has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Maria would enjoy if she were to incorporate her business.
- What is the basic accounting equation?
- (a) Define the terms assets, liabilities, and equity. (b) What items affect equity?
- Which of the following items are liabilities of Stanley Jewelry Stores?
 

(a) Cash.	(f) Equipment.
(b) Accounts payable.	(g) Salaries payable.
(c) Dividends.	(h) Service revenue.
(d) Accounts receivable.	(i) Rent expense.
(e) Supplies.	
- 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 president of the company dies.
  - Supplies are purchased on account.
  - An employee is fired.
- Indicate how the following business transactions affect the basic accounting equation.
  - Paid cash for janitorial services.
  - Purchased equipment for cash.
  - Received cash in exchange for ordinary shares.
  - Paid accounts payable in full.
- Listed below are some items found in the financial statements of Alex Greenspan Co. Indicate in which financial statement(s) the following items would appear.
 

(a) Service revenue.	(d) Accounts receivable.
(b) Equipment.	(e) Retained earnings.
(c) Advertising expense.	(f) Wages payable.
- In February 2011, Paula King invested an additional \$10,000 in Hardy Company. Hardy's accountant, Lance

### 34 Chapter 1 Accounting in Action

- Jones, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?
20. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's statement of financial position." Do you agree? Explain.
  21. Garcia Enterprises had an equity balance of \$168,000 at the beginning of the period. At the end of the accounting period, the equity balance was \$198,000.
    - (a) Assuming no additional investment or distributions during the period, what is the net income for the period?
    - (b) Assuming an additional investment of \$13,000 but no distributions during the period, what is the net income for the period?
  22. Summarized operations for J. R. Ross Co. for the month of July are as follows.  
 Revenues earned: for cash £20,000; on account £70,000.  
 Expenses incurred: for cash £26,000; on account £40,000.  
 Indicate for J. R. Ross Co. (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.
  23. The basic accounting equation is: Assets = Liabilities + Equity. Replacing the words in that equation with numeric amounts, what is Nestlé's accounting equation at December 31, 2008?



## BRIEF EXERCISES



Use basic accounting equation.  
(SO 6)

**BE1-1** Presented below is the basic accounting equation (in thousands). Determine the missing amounts.

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Equity</u>
(a)	¥90,000		¥50,000		?
(b)	?		¥40,000		¥70,000
(c)	¥94,000		?		¥60,000

Use basic accounting equation.  
(SO 6)

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

- (a) The liabilities of McGlone Company are \$120,000 and the equity is \$232,000. What is the amount of McGlone Company's total assets?
- (b) The total assets of McGlone Company are \$190,000 and its equity is \$80,000. What is the amount of its total liabilities?
- (c) The total assets of McGlone Company are \$800,000 and its liabilities are equal to one half of its total assets. What is the amount of McGlone Company's equity?

Use basic accounting equation.  
(SO 6)

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

- (a) If total assets increased €150,000 during the year and total liabilities decreased €80,000, what is the amount of equity at the end of the year?
- (b) During the year, total liabilities increased €100,000 and equity decreased €70,000. What is the amount of total assets at the end of the year?
- (c) If total assets decreased €80,000 and equity increased €120,000 during the year, what is the amount of total liabilities at the end of the year?

Solve accounting equation.  
(SO 6)

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

- (a) The liabilities of Cai Company are £90,000. Share capital—ordinary account is £150,000; dividends are £40,000; revenues, £450,000; and expenses, £320,000. What is the amount of Cai Company's total assets?
- (b) The total assets of Pereira Company are \$57,000. Share capital—ordinary account is \$25,000; dividends are \$7,000; revenues, \$50,000; and expenses, \$35,000. What is the amount of the company's total liabilities?
- (c) The total assets of Yap Co. are €600,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Yap Co.'s equity?

Identify assets, liabilities, and equity.

(SO 6)

**BE1-5** Indicate whether each of the following items is an asset (A), liability (L), or part of equity (E).

- |                               |                                  |
|-------------------------------|----------------------------------|
| _____ (a) Accounts receivable | _____ (d) Office supplies        |
| _____ (b) Salaries payable    | _____ (e) Share capital—ordinary |
| _____ (c) Equipment           | _____ (f) Notes payable          |

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

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

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

**BE1-7** Follow the same format as BE1-6 above. Determine the effect on assets, liabilities, and equity of the following three transactions.

- (a) Invested cash in the business for ordinary shares.
- (b) Paid a cash dividend.
- (c) Received cash from a customer who had previously been billed for services provided.

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

**BE1-8** Classify each of the following items as dividends (D), revenue (R), or expense (E).

- |                               |                             |
|-------------------------------|-----------------------------|
| _____ (a) Advertising expense | _____ (e) Dividends         |
| _____ (b) Commission revenue  | _____ (f) Rent revenue      |
| _____ (c) Insurance expense   | _____ (g) Utilities expense |
| _____ (d) Salaries expense    |                             |

*Classify items affecting equity.*  
(SO 7)

**BE1-9** Presented below are three transactions. Mark each transaction as affecting share capital—ordinary (C), dividends (D), revenue (R), expense (E), or not affecting equity (NE).

- \_\_\_\_\_ (a) Received cash for services performed.
- \_\_\_\_\_ (b) Paid cash to purchase equipment.
- \_\_\_\_\_ (c) Paid employee salaries.

*Determine effect of transactions on equity.*  
(SO 7)

**BE1-10** In alphabetical order below are statement of financial position items for Lopez Company at December 31, 2011. Kim Lopez is the owner of Lopez Company. Prepare a statement of financial position, following the format of Illustration 1-11.

Accounts payable	\$99,000
Accounts receivable	\$72,500
Cash	\$49,000
Share capital—ordinary	\$31,500

*Prepare a statement of financial position.*  
(SO 8)

**BE1-11** Indicate whether the following items would appear on the income statement (IS), statement of financial position (FP), or retained earnings statement (RE).

- |                                  |                           |
|----------------------------------|---------------------------|
| _____ (a) Notes payable          | _____ (d) Cash            |
| _____ (b) Advertising expense    | _____ (e) Service revenue |
| _____ (c) Share capital—ordinary | _____ (f) Dividends       |

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

**Do it! Review**



**Do it! 1-1** Indicate whether each of the five statements presented below is true or false. If false, state why.

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

1. The three steps in the accounting process are identification, recording, and examination.
2. The two most common types of external users are investors and creditors.
3. IFRSs are issued by the IASB.
4. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
5. The cost principle dictates that companies record assets at their cost and continue to report them at their cost over the time the asset is held.

**Do it! 1-2** Classify the following items as issuance of shares (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

*Evaluate effects of transactions on equity.*  
(SO 6)

- |                  |  |
|------------------|--|
| (1) Dividends    | (3) Advertising Expense                      |
| (2) Rent Revenue | (4) Shareholders invest cash in the business |

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Prepare tabular analysis.  
(SO 7)

**Do it! 1-3** Transactions made by Carbrera and Co., a law firm, for the month of March are shown below. Prepare a tabular analysis which shows the effects of these transactions on the accounting equation, similar to that shown in Illustration 1-10.

1. The company provided R20,000 of services for customers, on credit.
2. The company received R20,000 in cash from customers who had been billed for services [in transaction (1)].
3. The company received a bill for R2,000 of advertising but will not pay it until a later date.
4. The company paid a dividend of R5,000 in cash to shareholders.

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

**Do it! 1-4** Presented below is selected information related to Santos Company at December 31, 2011. Santos reports financial information monthly.

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

- (a) Determine the total assets of Santos Company at December 31, 2011.
- (b) Determine the net income that Santos Company reported for December 2011.
- (c) Determine the equity of Santos Company at December 31, 2011.

## EXERCISES



Classify the three activities of accounting.  
(SO 1)

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

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

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

### Instructions

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

Identify users of accounting information.  
(SO 2)

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

- |                             |                                 |
|-----------------------------|---------------------------------|
| _____ Customers             | _____ Store manager             |
| _____ Labor unions          | _____ Suppliers                 |
| _____ Marketing manager     | _____ Taxing agency             |
| _____ Production supervisor | _____ Vice president of finance |
| _____ Securities regulator  |                                 |

### Instructions

Identify the users as being either **external users** (E) or **internal users** (I).

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

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

**Instructions**

Identify each of the questions on the previous page as being more likely asked by an **internal user** (I) or an **external user** (E).

**E1-3** Larry Smith, president of Smith Company, has instructed Ron Rivera, the head of the accounting department for Smith Company, to report the company's recently acquired land in the company's accounting reports at a value of \$170,000 instead of its cost of \$100,000. Smith says, "I think we got a real deal on the purchase. It is probably worth \$170,000. Showing the land at \$170,000 will make our company look like a better investment when we try to attract new investors next month."

*Discuss ethics and the cost principle.*

(SO 3)

**Instructions**

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

**E1-4** The following situations involve accounting standards and assumptions.

*Use accounting concepts.*

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

(SO 4, 5)

**Instructions**

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

**E1-5** Meredith Cleaners has the following statement of financial position items.

Accounts payable	Accounts receivable
Cash	Notes payable
Cleaning equipment	Salaries payable
Cleaning supplies	Share capital—ordinary

*Classify accounts as assets, liabilities, and equity.*

(SO 6)

**Instructions**

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

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

*Analyze the effect of transactions.*

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

(SO 6, 7)

**Instructions**

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

**E1-7** Brandon Computer Timeshare Company entered into the following transactions during May 2011.

*Analyze the effect of transactions on assets, liabilities, and equity.*

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

(SO 6, 7)

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**Instructions**

Indicate with the appropriate letter whether each of the transactions on the previous page results in:

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

Analyze transactions and compute net income.  
(SO 7)

**E1-8** An analysis of the transactions made by S. Moses & Co., a certified public accounting firm, for the month of August is shown below. Each increase and decrease in equity is explained.

	Assets				=	Liabilities	+	Equity			
	Cash	Accounts Receivable	Supplies	Office Equipment				Accounts Payable	Share Capital	Retained Earnings	
								Rev.	Exp.	Div.	
1.	+\$15,000						+15,000				Issued Shares
2.	-2,000			+\$5,000	+\$3,000						
3.	-750		+\$750								
4.	+4,600	+\$3,700						+\$8,300			Service Revenue
5.	-1,500				-1,500						
6.	-2,000									-\$2,000	Dividends
7.	-650								-\$650		Rent Expense
8.	+450	-450									
9.	-4,900								-4,900		Salaries Expense
10.					+500				-500		Utilities Expense

**Instructions**

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

Prepare financial statements.  
(SO 8)

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

**Instructions**

Prepare an income statement and a retained earnings statement for August and a statement of financial position at August 31, 2011.

Determine net income (or loss).  
(SO 8)

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

December 31	Total Assets	Total Liabilities
2010	TL400,000	TL250,000
2011	TL460,000	TL300,000
2012	TL590,000	TL400,000

Lily began business on January 1, 2010, with an investment of TL100,000 from shareholders.

**Instructions**

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

- (a) 2010, assuming Lily paid TL15,000 in dividends for the year.
- (b) 2011, assuming shareholders made an additional investment of TL50,000 and Lily paid no dividends in 2011.
- (c) 2012, assuming shareholders made an additional investment of TL15,000 and Lily paid dividends of TL30,000 in 2012.

Analyze financial statements items.  
(SO 6, 7)

**E1-11** Two items are omitted from each of the following summaries of statement of financial position and income statement data for two companies for the year 2011, Craig Cantrel and Mills Enterprises.

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

**Instructions**

Determine the missing amounts.

**E1-12** The following information relates to Linda Stanley Co. for the year 2011.

Retained earnings, January 1, 2011	\$48,000	Advertising expense	\$ 1,800
Dividends during 2011	6,000	Rent expense	10,400
Service revenue	62,500	Utilities expense	3,100
Salaries expense	30,000		

Prepare income statement and retained earnings statement.

(SO 8)

**Instructions**

After analyzing the data, prepare an income statement and a retained earnings statement for the year ending December 31, 2011.

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

Correct an incorrectly prepared statement of financial position.

(SO 8)

**MENDEZ COMPANY**  
Statement of Financial Position  
December 31, 2011

<u>Assets</u>		<u>Liabilities</u>	
Equipment	€46,000	Share capital—ordinary	€50,000
Supplies	8,000	Retained earnings	17,500
Cash	15,000	Accounts payable	20,000
Dividends	10,000	Accounts receivable	(8,500)
Total assets	<u>€79,000</u>	Total equity and liabilities	<u>€79,000</u>

**Instructions**

Prepare a correct statement of financial position.

**E1-14** Deer Park, a public camping ground near the Lake Mead National Recreation Area, has compiled the following financial information as of December 31, 2011.

Revenues during 2011—camping fees	\$140,000	Notes payable	\$ 60,000
Revenues during 2011—general store	50,000	Expenses during 2011	150,000
Accounts payable	11,000	Supplies on hand	2,500
Cash on hand	23,000	Share capital—ordinary	20,000
Original cost of equipment	105,500	Retained earnings	?
Market value of equipment	140,000		

Compute net income and prepare a statement of financial position.

(SO 8)

**Instructions**

(a) Determine Deer Park's net income for 2011.

(b) Prepare a statement of financial position for Deer Park as of December 31, 2011.

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Prepare an income statement.  
(SO 8)

**E1-15** Presented below is financial information related to the 2011 operations of Silva Cruise Company.

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

### Instructions

Prepare the 2011 income statement for Silva Cruise Company.

Prepare a retained earnings statement.  
(SO 8)

**E1-16** Presented below is information related to Kevin and Johnson, Attorneys at Law.

Retained earnings, January 1, 2011	\$ 23,000
Legal service revenue—2011	350,000
Total expenses—2011	211,000
Assets, January 1, 2011	85,000
Liabilities, January 1, 2011	62,000
Assets, December 31, 2011	168,000
Liabilities, December 31, 2011	85,000
Dividends—2011	79,000

### Instructions

Prepare the 2011 retained earnings statement for Kevin and Johnson, Attorneys at Law.

Prepare a cash flow statement.  
(SO 8)

**E1-17** This information is for Borneo Company for the year ended December 31, 2011 (in thousands).

Cash received from revenues from customers	Rp600,000
Cash received for issuance of ordinary shares	350,000
Cash paid for new equipment	100,000
Cash dividends paid	20,000
Cash paid for expenses	410,000
Cash balance 1/1/11	30,000

### Instructions

Prepare the 2011 statement of cash flows for Borneo Company.

## PROBLEMS: SET A



Analyze transactions and compute net income.

(SO 6, 7)



**P1-1A** Barone's Repair Ltd. was started on May 1. A summary of May transactions is presented below.

- Shareholders invested £10,000 cash in the business in exchange for ordinary shares.
- Purchased equipment for £5,000 cash.
- Paid £400 cash for May office rent.
- Paid £500 cash for supplies.
- Incurred £250 of advertising costs in the *Beacon News* on account.
- Received £5,100 in cash from customers for repair service.
- Declared and paid a £1,000 cash dividend.
- Paid part-time employee salaries £2,000.
- Paid utility bills £140.
- Provided repair service on account to customers £750.
- Collected cash of £120 for services billed in transaction (10).

### Instructions

(a) Prepare a tabular analysis of the transactions, using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Share Capital, and Retained Earnings (with separate columns for Revenues, Expenses, and Dividends). Include

(a) Total retained earnings  
£2,060

margin explanations for any changes in Retained Earnings. Revenue is called Service Revenue.

- (b) From an analysis of the Retained Earnings columns, compute the net income or net loss for May.

(b) Net income £3,060

**P1-2A** On August 31, the statement of financial position of Nashville Veterinary Clinic showed Cash \$9,000, Accounts Receivable \$1,700, Supplies \$600, Office Equipment \$6,000, Accounts Payable \$3,600, Share Capital \$13,000, and Retained Earnings \$700. During September the following transactions occurred.

Analyze transactions and prepare income statement, retained earnings statement, and statement of financial position.

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

(SO 6, 7, 8)

Check figures next to some Problems give you a key number, to let you know if you are on the right track with your solution.

**Instructions**

- (a) Prepare a tabular analysis of the September transactions beginning with August 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + Share Capital—Ordinary + Retained Earnings + Revenues – Expenses – Dividends.
- (b) Prepare an income statement for September, a retained earnings statement for September, and a statement of financial position at September 30.

(a) Ending retained earnings \$4,630

(b) Net income \$4,930  
Total assets \$29,800

**P1-3A** On May 1, Yoon Flying School, a company that provides flying lessons, was started with an investment of ₩45,000,000 cash in the business. Following are the assets and liabilities of the company on May 31, 2011, and the revenues and expenses for the month of May (in thousands).

Prepare income statement, retained earnings statement, and statement of financial position.

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

(SO 8)

No additional investments were made in May, but the company paid dividends of ₩1,500,000 during the month.

**Instructions**

- (a) Prepare an income statement and a retained earnings statement for the month of May and a statement of financial position at May 31 (show numbers in thousands).
- (b) Prepare an income statement and a retained earnings statement for May assuming the following data are not included above: (1) ₩900,000 of revenue was earned and billed but not collected at May 31, and (2) ₩1,500,000 of fuel expense was incurred but not paid.

(a) Net income ₩2,500  
Total assets ₩76,800

(b) Net income ₩1,900

**P1-4A** Mark Miller started a delivery service, Miller Deliveries, on June 1, 2011. The following transactions occurred during the month of June.

Analyze transactions and prepare financial statements.

- June 1 Shareholders invested \$10,000 cash in the business in exchange for ordinary shares.
- 2 Purchased a used van for deliveries for \$12,000. Mark paid \$2,000 cash and signed a note payable for the remaining balance.
- 3 Paid \$500 for office rent for the month.
- 5 Performed \$4,400 of services on account.
- 9 Declared and paid \$200 in cash dividends.
- 12 Purchased supplies for \$150 on account.
- 15 Received a cash payment of \$1,250 for services provided on June 5.
- 17 Purchased gasoline for \$100 on account.

(SO 6, 7, 8)

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- 20 Received a cash payment of \$1,500 for services provided.
- 23 Made a cash payment of \$500 on the note payable.
- 26 Paid \$250 for utilities.
- 29 Paid for the gasoline purchased on account on June 17.
- 30 Paid \$1,000 for employee salaries.

**Instructions**

(a) Retained earnings \$3,850

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

Date	Assets				=	Liabilities			+	Equity									
	Cash	+	Accounts Receivable	+		Supplies	+	Delivery Van		=	Notes Payable	+	Accounts Payable	+	Share Capital	+	Retained Earnings		
															Rev.	-	Exp.	-	Div.

Include margin explanations for any changes in the Retained Earnings account in your analysis.

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

(b) Prepare an income statement for the month of June.  
(c) Prepare a statement of financial position at June 30, 2011.


Determine financial statement amounts and prepare retained earnings statement.

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

(SO 7, 8)

	<b>Karma Company</b>	<b>Yates Company</b>	<b>McCain Company</b>	<b>Dench Company</b>
January 1, 2011				
Assets	\$ 95,000	\$140,000	(g)	\$170,000
Liabilities	50,000	(d)	75,000	(j)
Equity	(a)	60,000	45,000	90,000
December 31, 2011				
Assets	(b)	137,000	200,000	(k)
Liabilities	55,000	75,000	(h)	80,000
Equity	60,000	(e)	130,000	170,000
Equity changes in year				
Additional investment	(c)	15,000	10,000	15,000
Dividends	25,000	(f)	14,000	20,000
Total revenues	350,000	420,000	(i)	520,000
Total expenses	320,000	385,000	342,000	(l)

**Instructions**

- (a) Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets – Liabilities = Equity = \$45,000.)
- (b) Prepare the retained earnings statement for Yates Company. Assume beginning retained earnings was \$20,000.
- (c)  Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the retained earnings statement to the income statement and statement of financial position.

**PROBLEMS: SET B**

Analyze transactions and compute net income.

(SO 6, 7)



**P1-1B** On April 1, Jenny Russo established Matrix Travel Agency. The following transactions were completed during the month.

1. Shareholders invested €10,000 cash in the business in exchange for ordinary shares.
2. Paid €400 cash for April office rent.
3. Purchased office equipment for €2,500 cash.
4. Incurred €300 of advertising costs in the *Chicago Tribune*, on account.
5. Paid €600 cash for office supplies.
6. Earned €9,500 for services provided: €3,000 cash is received from customers, and the balance of €6,500 is billed to customers on account.

7. Declared and paid a €200 cash dividend.
8. Paid *Chicago Tribune* amount due in transaction (4).
9. Paid employees' salaries €2,200.
10. Received €4,000 in cash from customers billed previously in transaction (6).

**Instructions**

- (a) Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Office Equipment, Accounts Payable, Share Capital, and Retained Earnings (with separate columns for Revenues, Expenses, and Dividends). Include margin explanation for any changes in Retained Earnings. (a) Ending retained earnings €6,400
- (b) From an analysis of the Retained Earnings columns, compute the net income or net loss for April. (b) Net income €6,600

**P1-2B** Cindy Belton opened a law office, Cindy Belton, Attorney at Law, on July 1, 2011. On July 31, the statement of financial position showed Cash \$4,000, Accounts Receivable \$1,500, Supplies \$500, Office Equipment \$5,000, Accounts Payable \$4,200, and Share Capital \$6,000, and Retained Earnings \$800. During August the following transactions occurred.

Analyze transactions and prepare income statement, retained earnings statement, and statement of financial position.

(SO 6, 7, 8)



1. Collected \$1,400 of accounts receivable due from clients.
2. Paid \$2,700 cash for accounts payable due.
3. Earned revenue of \$9,000 of which \$3,000 is collected in cash and the balance is due in September.
4. Purchased additional office equipment for \$1,000, paying \$400 in cash and the balance on account.
5. Paid salaries \$3,000, rent for August \$900, and advertising expenses \$350.
6. Declared and paid a \$750 cash dividend.
7. Received \$2,000 from Standard Federal Bank; the money was borrowed on a 4-month note payable.
8. Incurred utility expenses for month on account \$250.

**Instructions**

- (a) Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + Share Capital—Ordinary + Retained Earnings + Revenues – Expenses – Dividends. (a) Ending expenses \$4,500
- (b) Prepare an income statement for August, a retained earnings statement for August, and a statement of financial position at August 31. Net income \$4,500  
Total assets \$14,900

**P1-3B** Divine Cosmetics Co., a company that provides individual skin care treatment, was started on June 1 with an investment of ¥26,200,000 cash. Following are the assets and liabilities of the company at June 30 and the revenues and expenses for the month of June (in thousands).

Prepare income statement, retained earnings statement, and statement of financial position. (SO 8)

Cash	¥11,000	Notes Payable	¥13,000
Accounts Receivable	4,000	Accounts Payable	1,200
Service Revenue	6,000	Supplies Expense	1,600
Cosmetic Supplies	2,000	Gas and Oil Expense	800
Advertising Expense	500	Utilities Expense	300
Equipment	25,000		

Shareholders made no additional investments in June. The company paid a cash dividend of ¥1,200 during the month.

**Instructions**

- (a) Prepare an income statement and a retained earnings statement for the month of June and a statement of financial position at June 30, 2011. (a) Net income ¥2,800  
Total assets ¥42,000
- (b) Prepare an income statement and a retained earnings statement for June assuming the following data are not included above: (1) ¥800,000 of revenue was earned and billed but not collected at June 30, and (2) ¥100,000 of gas and oil expense was incurred but not paid. (b) Net income ¥3,500

**P1-4B** Laura Geller started a consulting firm, Geller Consulting, on May 1, 2011. The following transactions occurred during the month of May.

Analyze transactions and prepare financial statements.

(SO 6, 7, 8)

- May 1 Geller invested \$8,000 cash in the business in exchange for shares.
- 2 Paid \$800 for office rent for the month.
- 3 Purchased \$500 of supplies on account.

## 44 Chapter 1 Accounting in Action

- 5 Paid \$50 to advertise in the *County News*.
- 9 Received \$3,000 cash for services provided.
- 12 Declared and paid a \$700 cash dividend.
- 15 Performed \$5,300 of services on account.
- 17 Paid \$3,000 for employee salaries.
- 20 Paid for the supplies purchased on account on May 3.
- 23 Received a cash payment of \$3,000 for services provided on account on May 15.
- 26 Borrowed \$5,000 from the bank on a note payable.
- 29 Purchased office equipment for \$2,800 on account.
- 30 Paid \$150 for utilities.

### Instructions

(a) Ending retained earnings  
\$3,600

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

Date	Assets				=	Liabilities		+	Equity										
	Cash	+	Accounts Receivable	+		Supplies	+		Office Equipment	=	Notes Payable	+	Accounts Payable	+	Share Capital	+	Retained Earnings		
															Rev.	-	Exp.	-	Div.

Include margin explanations for any changes in the Retained Earnings account in your analysis.

(b) Net income \$4,300  
(c) Cash \$13,800

(b) Prepare an income statement for the month of May.  
(c) Prepare a statement of financial position at May 31, 2011.


Determine financial statement amounts and prepare retained earnings statement.

(SO 7, 8)

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

	<b>McKane Company</b>	<b>Selara Company</b>	<b>Gordon Company</b>	<b>Hindi Company</b>
January 1, 2011				
Assets	\$ 80,000	\$ 90,000	(g)	\$150,000
Liabilities	50,000	(d)	75,000	(j)
Equity	(a)	50,000	49,000	100,000
December 31, 2011				
Assets	(b)	117,000	180,000	(k)
Liabilities	55,000	72,000	(h)	80,000
Equity	40,000	(e)	100,000	145,000
Equity changes in year				
Additional investment	(c)	8,000	10,000	15,000
Dividends	10,000	(f)	12,000	10,000
Total revenues	350,000	400,000	(i)	500,000
Total expenses	335,000	385,000	360,000	(l)

### Instructions

- (a) Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets – Liabilities = Equity = \$30,000.)
- (b) Prepare the retained earnings statement for McKane Company. Assume beginning retained earnings was \$0.
- (c)  Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the retained earnings statement to the income statement and statement of financial position.

## CONTINUING COOKIE CHRONICLE

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

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

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

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

#### Instructions

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

## BROADENING YOUR PERSPECTIVE

### FINANCIAL REPORTING AND ANALYSIS

#### Financial Reporting Problem: Cadbury plc

**BYP1-1** The actual financial statements of Cadbury, as presented in the company's 2008 Annual Report, are contained in Appendix A (at the back of the textbook).

#### Instructions

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

- (a) What were Cadbury's total assets at December 31, 2008? At December 31, 2007?
- (b) How much cash (and cash equivalents) did Cadbury have on December 31, 2008?
- (c) What amount of accounts (trade) payable did Cadbury report on December 31, 2008? On December 31, 2007?
- (d) What were Cadbury's revenues in 2007? In 2008?
- (e) What is the amount of the change in Cadbury's net income from 2007 to 2008? (*Hint:* Use "total" column.)

#### Comparative Analysis Problem: Cadbury plc vs. Nestlé S.A.

**BYP1-2** Cadbury's financial statements are presented in Appendix A. Nestlé's financial statements are presented in Appendix B.

#### Instructions

Refer to the financial statements and answer the following questions.

- (a) Based on the information contained in these financial statements, determine the following for each company.
  - (1) Total assets at December 31, 2008, for Cadbury, and for Nestlé at December 31, 2008.
  - (2) Accounts (notes) receivable, net at December 31, 2008, for Cadbury and at December 31, 2008, for Nestlé.
  - (3) Net sales for year ended in 2008.
  - (4) Net income for year ended in 2008.
- (b) What percentage does receivables represent of total assets for the two companies? What percentage does net income represent of sales for the two companies?



## Exploring the Web

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

**Address:** [www.careers-in-accounting.com](http://www.careers-in-accounting.com), or go to [www.wiley.com/college/veygandtfrs](http://www.wiley.com/college/veygandtfrs)

### Instructions

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

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

## CRITICAL THINKING



## Decision Making Across the Organization

**BYP1-4** Mary and Jack Gray, local golf stars, opened the Chip-Shot Driving Range Company on March 1, 2011. They invested \$25,000 cash and received ordinary shares in exchange for their investment. A caddy shack was constructed for cash at a cost of \$8,000, and \$800 was spent on golf balls and golf clubs. The Grays leased five acres of land at a cost of \$1,000 per month and paid the first month’s rent. During the first month, advertising costs totaled \$750, of which \$150 was unpaid at March 31, and \$400 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company’s bank account. On March 15, Mary and Jack received a dividend of \$1,000. A \$100 utility bill was received on March 31 but was not paid. On March 31, the balance in the company’s bank account was \$18,900.

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

### Instructions

With the class divided into groups, answer the following.

- How could the Grays have concluded that the business operated at a loss of \$6,100? Was this a valid basis on which to determine net income?
- How could the Grays have concluded that the business operated at a net income of \$2,450? (*Hint:* Prepare a statement of financial position 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 earned in March?

## Communication Activity

**BYP1-5** Lynn Benedict, the bookkeeper for London Company, has been trying to get the statement of financial position to balance. The company’s statement of financial position is shown below.

### LONDON COMPANY Statement of Financial Position For the Month Ended December 31, 2011

Assets		Liabilities	
Equipment	£25,500	Share capital—ordinary	£26,000
Cash	9,000	Accounts receivable	(6,000)
Supplies	2,000	Retained earnings	(2,000)
Accounts payable	(8,000)	Notes payable	10,500
	<u>£28,500</u>		<u>£28,500</u>

**Instructions**

Explain to Lynn Benedict in a memo why the original statement of financial position is incorrect, and what should be done to correct it.

**Ethics Case**

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

**Instructions**

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

**Answers to Insight and Accounting Across the Organization Questions****p. 11 How Will Accounting Help Me?**

Q: How might accounting help you?

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

**p. 24 What Do Vodafone, Walt Disney, and JJB Sports Have in Common?**

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

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

Q: What if you owned a college bookstore?

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

Q: Why choose those year-ends?

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

**Answers to Self-Study Questions**

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

