Accounting Activities and Users

**LEARNING OBJECTIVE 1**

Identify the activities and users associated with accounting.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? What was the undergraduate degree chosen by **Nike** founder Phil Knight, **Home Depot** co-founder Arthur Blank, former acting director of the **Federal Bureau of Investigation (FBI)** Thomas Pickard, and numerous members of Congress? Accounting.[1](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-note-0001) Why did these people choose accounting? They wanted to understand what was happening financially to their organizations. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

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

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

**Three Activities**

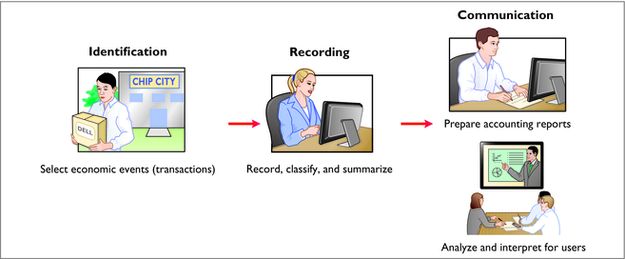
As a starting point to the accounting process, a company **identifies** the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by **PepsiCo**, the provision of cell phone services by **AT&T**, and the payment of wages by **Facebook**.

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

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

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information. Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships. Interpretation involves **explaining the uses**, **meaning**, **and limitations of reported data**. Appendices A–E show the financial statements of **Apple Inc.**, **PepsiCo Inc.**, **The Coca-Cola Company**, **Amazon.com, Inc.**, and **Wal-Mart Stores, Inc.**, respectively. (In addition, in the [*A Look at IFRS*](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fea-0013) section at the end of each chapter, the French company **Louis Vuitton Moët Hennessy** is analyzed.) We refer to these statements at various places throughout the textbook. At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

[**Illustration 1.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0001) summarizes the activities of the accounting process.



[**ILLUSTRATION 1.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0001-a) **The activities of the accounting process**

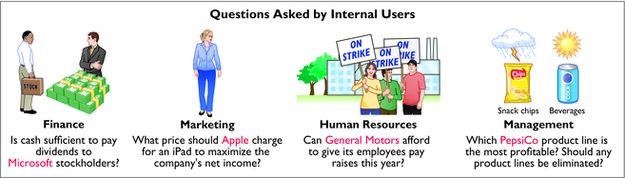
You should understand that the accounting process **includes** the bookkeeping function. **Bookkeeping** usually involves **only** the recording of economic events. It is therefore just one part of the accounting process. In total, accounting involves **the entire process of identifying**, **recording**, **and communicating economic events**.[2](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-note-0003)

**Who Uses Accounting Data**

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

**Internal Users**

**Internal users** of accounting information are the managers who plan, organize, and run a 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**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0002).



[**ILLUSTRATION 1.2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0002-a) **Questions that internal users ask**

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.

**Accounting Across the Organization   Clif Bar & Company**

**Owning a Piece of the Bar**



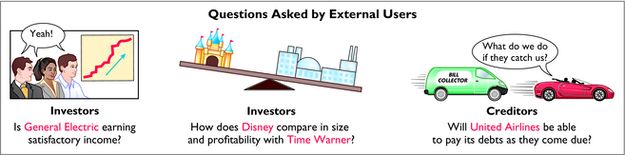
The original Clif Bar® energy bar was created in 1990 after six months of experimentation by Gary Erickson and his mother in her kitchen. Today, the company has almost 300 employees and is considered one of the leading Landor's Breakaway Brands®. One of **Clif Bar & Company**'s proudest moments was the creation of an employee stock ownership plan (ESOP) in 2010. This plan gives its employees 20% ownership of the company. The ESOP also resulted in Clif Bar enacting an open-book management program, including the commitment to educate all employee-owners about its finances. Armed with basic accounting knowledge, employees are more aware of the financial impact of their actions, which leads to better decisions.

**What are the benefits to the company and its employees of making the financial statements available to all employees?** **(Go to WileyPLUS for this answer and additional questions.)**

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

**External Users**

**External users** are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors. **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company. **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money. [**Illustration 1.3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0003) shows some questions that investors and creditors may ask.



[**ILLUSTRATION 1.3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0003-a) **Questions that external users ask**

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

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

### DO IT! 1 | Basic Concepts

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

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

### ACTION PLAN

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

#### Solution

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

Related exercise material: [**DO IT! 1.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0114)**,**[**E1.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0122)**, and**[**E1.2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0123).

## The Building Blocks of Accounting

### LEARNING OBJECTIVE 2

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

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be present—ethical behavior.

### Ethics in Financial Reporting

People won't gamble in a casino if they think it is “rigged.” Similarly, people won't play the stock market if they think prices are rigged. At one time, the financial press was full of articles about financial scandals at **Enron**, **WorldCom**, **HealthSouth**, and **AIG**, As more scandals came to light, a mistrust of financial reporting in general seemed to be developing. One article in the *Wall Street Journal* noted that “repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent stock prices tumbling.” Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

United States regulators and lawmakers were very concerned that the economy would suffer if investors lost confidence in corporate accounting because of unethical financial reporting. In response, Congress passed the **Sarbanes-Oxley Act (SOX)** to reduce unethical corporate behavior and decrease the likelihood of future corporate scandals (see [**Ethics Note**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0004)). As a result of SOX, top management must now certify the accuracy of financial information. In addition, penalties for fraudulent financial activity are much more severe. Also, SOX increased the independence requirements of the outside auditors who review the accuracy of corporate financial statements and increased the oversight role of boards of directors.

#### ETHICS NOTE

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

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

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

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

When analyzing these various ethics cases and your own ethical experiences, you should apply the three steps outlined in [**Illustration 1.4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0004).

|  |  |  |  |
| --- | --- | --- | --- |
| https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/images/c01/w0006.jpg | **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. |

[**ILLUSTRATION 1.4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0004-a) **Steps in analyzing ethics cases and situations**

***Insight boxes provide examples of business situations from various perspectives—ethics, investor, international, and corporate social responsibility. Guideline answers to the critical thinking questions as well as additional questions are available in WileyPLUS*.**

### Ethics Insight   Dewey & LeBoeuf LLP

#### I Felt the Pressure—Would You?



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

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

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

**Source:** Ashby Jones, “Guilty Pleas of Dewey Staff Detail the Alleged Fraud,” *Wall Street Journal* (March 28, 2014).

**Why did these employees lie, and what do you believe should be their penalty for these lies? (Go to WileyPLUS for this answer and additional questions.)**

### Generally Accepted Accounting Principles

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

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)** (see [**International Note**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0005)).

#### INTERNATIONAL NOTE

**Over 115 countries use international standards (called IFRS). For example, all companies in the European Union follow IFRS. The differences between U.S. and international standards are not generally significant.**

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

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, in recent years the two standard-setting bodies have made efforts to reduce the differences between U.S. GAAP and IFRS. This process is referred to as **convergence**. As a result of these convergence efforts, someday there may 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 highlight any major differences between GAAP and IFRS in *International Notes* (as shown in the margin here) and provide a more in-depth discussion in the *A Look at IFRS* section at the end of each chapter.

### International Insight

#### The Korean Discount



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

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

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

**What is meant by the phrase “make the country's businesses more transparent”? Why would increasing transparency spur economic growth? (Go to WileyPLUS for this answer and additional questions.)**

### Measurement Principles

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation (see [**Helpful Hint**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0006)). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

#### HELPFUL HINT

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

***Helpful Hints further clarify concepts being discussed*.**

#### Historical Cost Principle

The **historical cost principle** (or cost principle) dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if **Best Buy** purchases land for $300,000, the company initially reports it in its accounting records at $300,000. But what does Best Buy do if, by the end of the next year, the fair value of the land has increased to $400,000? Under the historical cost principle, it continues to report the land at $300,000.

#### 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 price information is usually readily available for these types of assets. In determining which measurement principle to use, companies weigh the factual nature of cost figures versus the relevance of fair value. In general, most companies choose to use cost. Only in situations where assets are actively traded, such as investment securities, do companies apply the fair value principle extensively.

### Assumptions

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

#### Monetary Unit Assumption

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

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

#### Economic Entity Assumption

**An economic entity can be any organization or unit in society.** It may be a company (such as **Crocs, Inc.**), a governmental unit (the state of Ohio), a municipality (Seattle), a school district (St. Louis District 48), or a church (Southern Baptist). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities (see [**Ethics Note**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0008)). To illustrate, Sally Rider, owner of Sally's Boutique, must keep her personal living costs separate from the expenses of the business. Similarly, **J. Crew** and **Gap Inc.** are segregated into separate economic entities for accounting purposes.

#### ETHICS NOTE

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

##### Proprietorship.

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

##### Partnership.

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

##### Corporation.

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

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

### Accounting Across the Organization

#### Spinning the Career Wheel



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

* **General management:** Managers at **Ford Motors**, Massachusetts General Hospital, California State University—Fullerton, a **McDonald's** franchise, and a **Trek** bike shop all need to understand accounting data in order to make wise business decisions.
* **Marketing:** Marketing specialists at **Procter & Gamble** must be sensitive to costs and benefits, which accounting helps them quantify and understand. Making a sale is meaningless unless it is a profitable sale.
* **Finance:** Do you want to be a banker for **Citicorp**, an investment analyst for **Goldman Sachs**, or a stock broker for **Merrill Lynch**? These fields rely heavily on accounting knowledge to analyze financial statements. In fact, it is difficult to get a good job in a finance function without two or three courses in accounting.
* **Real estate:** Are you interested in being a real estate broker for **Prudential Real Estate**? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

**How might accounting help you? (Go to WileyPLUS for this answer and additional questions.)**

### DO IT! 2 | Building Blocks of Accounting

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

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

### ACTION PLAN

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

#### Solution

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

Related exercise material: [**DO IT! 1.2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0115)**,**[**E1.3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0126)**, and**[**E1.4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0127)**.**

## The Accounting Equation

### LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **Alphabet Inc.** has total assets of approximately $167.5 billion. Liabilities and owner's equity are the rights or claims against these resources. Thus, Alphabet has $167.5 billion of claims against its $167.5 billion of assets. Claims of those to whom the company owes money (creditors) are called **liabilities**. Claims of owners are called **owner's equity**. Alphabet has liabilities of $28.5 billion and owners' equity of $139.0 billion.

We can express the relationship of assets, liabilities, and owner's equity as an equation, as shown in [**Illustration 1.5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0005).

Assets=Liabilities+Owner's EquityAssets = Liabilities + Owner's Equity

[**ILLUSTRATION 1.5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0005-a) **The basic accounting equation**

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

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

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

### Assets

As noted above, **assets** are resources a business owns. The business uses its assets in carrying out such activities as production and sales. The common characteristic possessed by all assets is **the capacity to provide future services or benefits**. In a business, that service potential or future economic benefit eventually results in cash inflows (receipts). For example, consider Campus Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Campus Pizza 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 **salaries and wages payable** to employees and **sales and real estate taxes payable** to the local government.

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

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

### Owner's Equity

The ownership claim on total assets is **owner's equity** (see [**Helpful Hint**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0009)). It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or owners. To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets. The remainder is the owner's claim on the assets—the owner's equity. Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

#### HELPFUL HINT

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

#### Increases in Owner's Equity

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

##### Investments by Owner.

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

##### Revenues.

**Revenues** are the **increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business**. Revenues usually result in an increase in an asset. They may arise from different sources and are called different names depending on the nature of the business. Campus Pizza, for instance, has two categories of sales revenues—pizza sales and beverage sales.

#### Decreases in Owner's Equity

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

##### Drawings.

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

##### Expenses.

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

In summary, owner's equity is increased by an owner's investments and by revenues from business operations. Owner's equity is decreased by an owner's withdrawals of assets and by expenses. [**Illustration 1.6**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0006) expands the basic accounting equation by showing the items that comprise owner's equity. This format is referred to as the **expanded accounting equation**.

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

[**ILLUSTRATION 1.6**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0006-a) **Expanded accounting equation**

### DO IT! 3 | Owner's Equity Effects

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

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

### ACTION PLAN

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

#### Solution

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

Related exercise material: [**BE1.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0088)**,**[**BE1.2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0089)**,**[**BE1.3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0093)**,**[**BE1.4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0097)**,**[**BE1.5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0101)**,**[**BE1.6**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-1006)**,**[**DO IT! 1.3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0116)**, and**[**E1.5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0128)**.**

## Analyzing Business Transactions

### LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.



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

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

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** stated, “We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area.” In addition, many companies have upgraded their accounting information systems in response to the requirements of Sarbanes-Oxley.

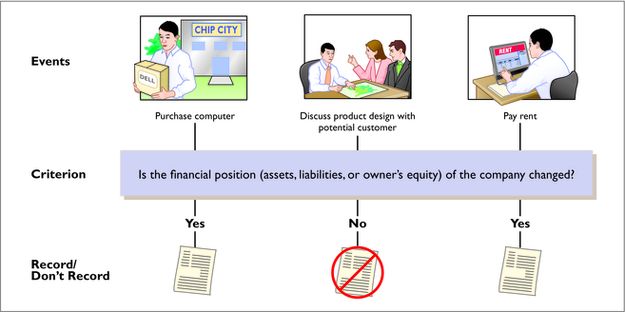
Accounting information systems rely on a process referred to as **the accounting cycle**. As you can see from the graphic above, the accounting cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. We explain each of the steps, starting in this chapter and continuing in Chapters [2](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c02.xhtml)–[4](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c04.xhtml).

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

### Accounting Transactions

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

Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions. Employees will earn wages, and suppliers will deliver ordered merchandise. The company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. [**Illustration 1.7**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0007) demonstrates the transaction identification process.



[**ILLUSTRATION 1.7**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0007-a) **Transaction identification process**

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

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

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

### Transaction Analysis

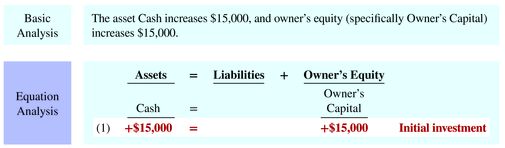
To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte, a smartphone app development company (see [Helpful Hint](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0011)). Softbyte is the creation of Ray Neal, an entrepreneur who wants to create focused apps that inspire and engage users of all ages. Ray was encouraged to start his own business after the success of “FoodAlert,” a customizable app he developed that tracks the daily location of local food trucks. The following business transactions occur during Softbyte's first month of operations.

#### HELPFUL HINT

**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.**

##### Transaction (1). Investment of Cash by Owner.

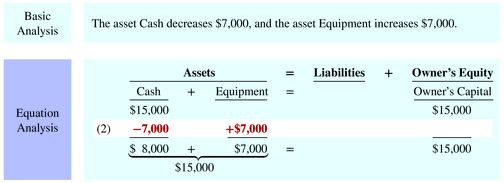
Ray Neal starts a smartphone app development company which he names Softbyte. On September 1, 2020, he invests $15,000 cash in the business. This transaction results in an equal increase in assets and owner's equity.



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

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

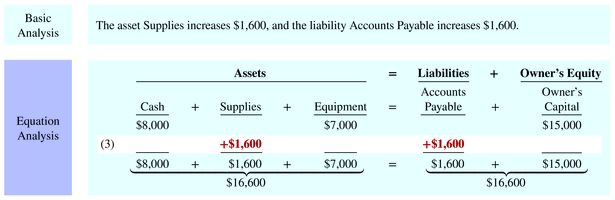
Softbyte purchases computer equipment for $7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.



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

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

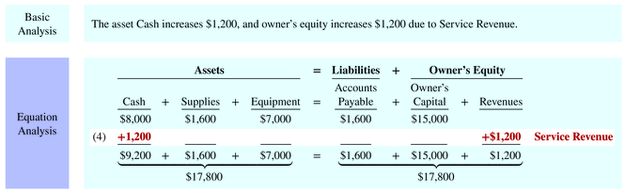
Softbyte purchases headsets (and other computer accessories expected to last several months) for $1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October. This transaction is a purchase on account (a credit purchase). Assets increase because of the expected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



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

##### Transaction (4). Services Performed for Cash.

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

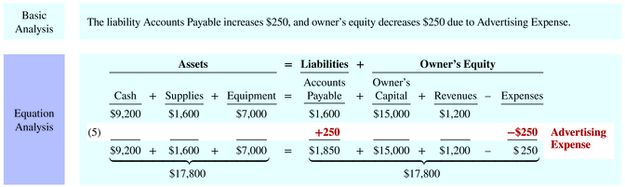


The two sides of the equation balance at $17,800. Service Revenue is included in determining Softbyte's net income.

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

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

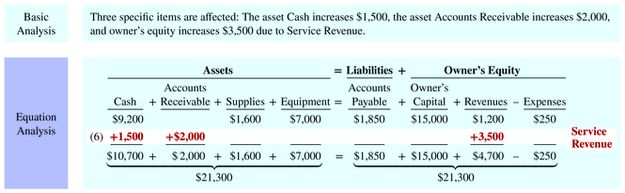
Softbyte receives a bill for $250 from the *Daily News* for advertising on its online website but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in owner's equity.



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

##### Transaction (6). Services Performed for Cash and Credit.

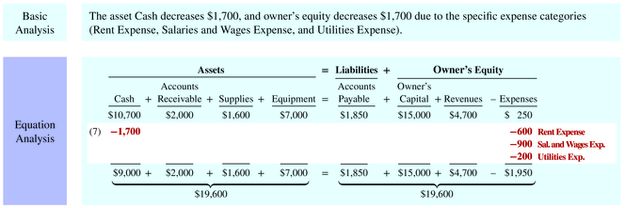
Softbyte performs $3,500 of app development services for customers. The company receives cash of $1,500 from customers, and it bills the balance of $2,000 on account. This transaction results in an equal increase in assets and owner's equity.



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

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

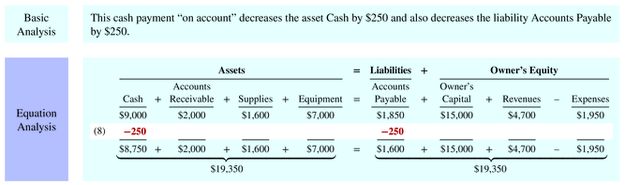
Softbyte pays the following expenses in cash for September: office rent $600, salaries and wages of employees $900, and utilities $200. These payments result in an equal decrease in assets and owner's equity.



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

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

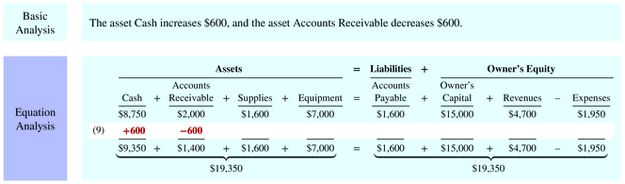
Softbyte pays its $250 *Daily News* bill in cash. The company previously [in Transaction (5)] recorded the bill as an increase in Accounts Payable and a decrease in owner's equity.



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

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

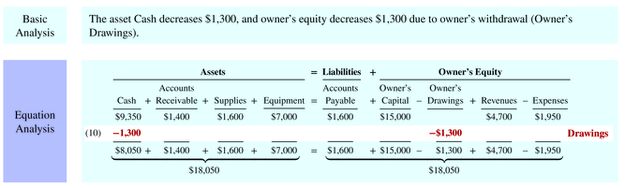
Softbyte receives $600 in cash from customers who had been billed for services [in Transaction (6)]. Transaction (9) does not change total assets, but it changes the composition of those assets.



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

##### Transaction (10). Withdrawal of Cash by Owner.

Ray Neal withdraws $1,300 in cash from the business for his personal use. This transaction results in an equal decrease in assets and owner's equity.



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

### Summary of Transactions

[**Illustration 1.8**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008) summarizes the September transactions of Softbyte to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction.

A table represents a summary of Softbyte transactions. The transaction is displayed in accounting analysis format, which begins with the accounting equation expressed as: Assets equals Liabilities plus Owner’s equity. Asset is shown as a sum of Cash, Accounts receivable, Supplies, and Equipment. While Accounts payable is listed under Liabilities. Owner’s equity is expressed as Owner’s capital minus Owner’s drawings plus Revenues minus Expenses. The eleven transactions are listed as follows: Transaction numbered (1) shows an increase of $15,000 as Cash under Assets and an increase of $15,000 as Owner’s capital under Owner's equity; labelled as Initial investment. Transaction numbered (2) shows a decrease of 7,000 as Cash and an increase of $7,000 as Equipment  under Assets. Transaction numbered (3) shows an increase of $1,600 as Supplies under Assets and an increase of $1,600 as Accounts payable under Liabilities. Transaction numbered (4) shows an increase of 1,200 as Cash under Assets and increase of $1,200 as Revenues under Owner's equity; labelled as Service Revenue. Transaction numbered (5) shows an increase of 250 as Accounts payable under Liabilities and a decrease of $250 as Expense under Owner's equity; labelled as Advertising expense. Transaction numbered (6) shows an increase of 1,500 as Cash and $2,000 as Accounts receivable under Assets and an increase of 3,500 as Revenues under Owner's equity; labelled as Service Revenue. Transaction numbered (7) shows a decrease of 600, 900, and 200 as Cash under Assets and a decrease of 600, 900, and 200 as Expenses under Owner’s equity; labelled as Rent expense, Salaries and wages expense, and Utilities expense, respectively. Transaction numbered (8) shows a decrease of 250 as Cash under Assets and a decrease of 250 as Accounts payable under Liabilities. Transaction numbered (9) shows an increase of 600 as Cash and a decrease of 600 as Accounts receivable under Assets. Transaction numbered (10) shows a decrease of 1,300 as Cash under Assets and a decrease of 1,300 $ as Owner’s drawings under Owner’s equity; labelled as Drawings. The total is shown as: Cash ($8,050) plus Accounts receivable ($1,400) plus Supplies ($1,600) plus Equipment ($7,000) equals Accounts payable ($1,600) plus Owner’s capital ($15,000) minus Owner’s drawings ($1,300) plus Revenues ($4,700) minus Expenses ($1,950).  

[**ILLUSTRATION 1.8**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008-a) **Tabular summary of Softbyte transactions**

[Illustration 1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008) demonstrates some significant facts:

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

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

### DO IT! 4 | Tabular Analysis

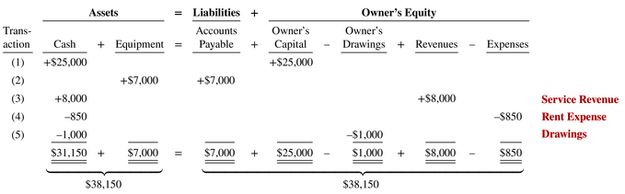
Transactions made by Virmari & Co., a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in [Illustration 1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008).

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

### 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



Related exercise material: [**BE1.7**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0102)**,**[**BE1.9**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0111)**,**[**DO IT! 1.4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0117)**,**[**E1.6**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0129)**,**[**E1.7**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0130)**, and**[**E1.8**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0138)**.**

## The Four Financial Statements

### LEARNING OBJECTIVE 5

Describe the four financial statements and how they are prepared.

Companies prepare four financial statements from the summarized accounting data (see [**Helpful Hint**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0013)):

#### HELPFUL HINT

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

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

These statements provide relevant financial data for internal and external users. [**Illustration 1.9**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009) shows the financial statements of Softbyte.

An illustration shows the relationship between the financial statements of Softbyte including the Income Statement, Statement of Owner's Equity, Balance Sheet, and Cash Flow Statement. The first statement displays a three-line heading consisting of name of the company, Softbyte; the type of statement, Income Statement; and the period for which the statement has been made, For the Month Ended September 30, 2020. There are two sections in this statement; the first section, Revenues, has a label, (indented) Service Revenue of $4,700, which is displayed in the far right column. The second section, Expenses, has the following entries under it, which are slightly indented in the next line: Salaries and Wages Expense, $900; Rent Expense, 600; Advertising Expense, 250; Utilities Expense, 200; these amounts are listed in the column second to the right. The sum, is entered on the line below the expenses with a label, further indented, of Total Expenses displayed in the far right column as 1,950. The line below is labeled Net income, and is determined by subtracting Total Expenses from Revenues, calculated as $2,750, displayed in the far right column and highlighted in red. The second statement has a three-line heading consisting of the name of the company, Softbyte; the type of statement, statement of owner’s Equity; and the period for which the statement is prepared, Statement for the month ended September 30, 2020. The entries are listed as follows: Owner's Capital dated September 1, 2020 is $0 ; add investments of  $15,000 , and the net income 2,750 carried from income statement and highlighted in red and numbered 1. The sum of the above three terms is calculated to be 17,750; Drawings of amount 1,300 are subtracted from it, resulting in Owner's capital dated September 30, 2020 displayed as $16,450, and highlighted in red.  The third statement is titled balance sheet for the month ended September 30, 2020. There are two sections in this statement. The first section, Asset shows a list of account titles on the left side with their respective amount on the right side as follows: Cash, $8,050 , is highlighted in red; Accounts Receivable, 1,400; Supplies, 1,600; Equipment, 7,000; the sum is calculated to be 18,050.  The second section, Liabilities and Owner’s Equity shows account name, Accounts payable, under liabilities displayed as $1,600 . Under Owner’s Equity, Owner's capital is displayed as 16,450 and highlighted in red. The sum, Total liabilities and owner’s equity is displayed as $18,050.  An arrow from Owner's drawings in the statement of owner’s equity points towards owner’s capital of 16,450 and numbered 2. The fourth statement is titled Cash flow statement for the month ended September 30, 2020. This is divided into three sections, cash flows from operating activities, cash flow from investing activities, cash flows from financing activities. The account titles under cash flows from operating activities includes: Cash receipts from customers, $3,300 (slightly indented); plus cash payments for expenses, negative 1,950 (slightly indented), with net cash provided by operating activities (further indented) displayed as 1,350 in the far right column. Under cash flows from investing activities, purchase of equipment is displayed as negative 7,000 (slightly indented), with net cash used by investing activities slightly indented in the next line and displayed as negative 7,000 in the far right column. Under cash flows from financing activities and slightly indented is, investments by owner displayed as $15,000; drawings by owner displayed as negative 1,300 , with net cash provided by financing activities, slightly indented in the next line and displayed as 13,700 on the right side. The sum of the above three subtotals is net increase in cash, displayed as 8,050. Below it, cash at the beginning of the period, dated September 1, 2020 is displayed as 0. The cash at the end of the period dated September 30, 2020 is displayed as $8,050 and highlighted in red. An arrow from cash in the balance sheet points towards cash at the end of the period, and is numbered 3.

[**ILLUSTRATION 1.9**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009-a) **Financial statements and their interrelationships**

Note that the statements shown in [Illustration 1.9](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009) are interrelated:

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

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

Be sure to carefully examine the format and content of each statement in [Illustration 1.9](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009). We describe the essential features of each in the following sections.

### Income Statement

The income statement reports the revenues and expenses for a specific period of time (see [**Alternative Terminology**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0014)). (In Softbyte's case, this is “For the Month Ended September 30, 2020.”) Softbyte's income statement is prepared from the data appearing in the owner's equity columns of [Illustration 1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008).

#### ALTERNATIVE TERMINOLOGY

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

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

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

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

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

### Owner's Equity Statement

The owner's equity statement reports the changes in owner's equity for a specific period of time. The time period is the same as that covered by the income statement (in Softbyte's case, this is “For the Month Ended September 30, 2020”). Data for the preparation of the owner's equity statement come from the owner's equity columns of the tabular summary ([Illustration 1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008)) and from the income statement. The first line of the statement shows the beginning owner's equity amount (which was zero at the start of the business). Then come the owner's investments, net income (or loss), and the owner's drawings. This statement indicates **why** owner's equity has increased or decreased during the period.

What if Softbyte had reported a net loss in its first month? Let's assume that during the month of September 2020, Softbyte lost $10,000. [**Illustration 1.10**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0010) shows the presentation of a net loss in the owner's equity statement.

| **Softbyte Owner's Equity Statement For the Month Ended September 30, 2020** | | | | |
| --- | --- | --- | --- | --- |
|  | Owner's capital, September 1 |  | $   –0– |  |
| Add: Investments |  | 15,000 |
|  |  | 15,000 |
| Less: Drawings | $ 1,300 |  |
| **Net loss** | **10,000** | 11,300 |
| Owner's capital, September 30 |  | $ 3,700 |

[**ILLUSTRATION 1.10**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0010-a) **Presentation of net loss**

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

### Balance Sheet

Softbyte's balance sheet reports the assets, liabilities, and owner's equity at a specific date (in Softbyte's case, September 30, 2020). The company prepares the balance sheet from the column headings of the tabular summary ([Illustration 1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008)) and the month-end data shown in its last line.

Observe that the balance sheet lists assets at the top, followed by liabilities and owner's equity. Total assets must equal total liabilities and owner's equity. Softbyte reports only one liability—accounts payable—in its balance sheet. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in [**Illustration 1.11**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0011).

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

[**ILLUSTRATION 1.11**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0011-a) **Presentation of liabilities**

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

### Statement of Cash Flows

The primary purpose of a statement of cash flows is to provide financial information about the cash receipts and cash payments of a company for a specific period of time (see [**Helpful Hint**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-0015)). To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's operating, investing, and financing activities. In addition, the statement shows the net increase or decrease in cash during the period, and the amount of cash at the end of the period.

#### HELPFUL HINT

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

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's statement of cash flows in [Illustration 1.9](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009), cash increased $8,050 during the period. Net cash provided by operating activities increased cash $1,350 (cash receipts from revenue less cash payments for expenses). Cash flow from investing activities decreased cash $7,000 (purchase of equipment). And cash flow from financing activities increased cash $13,700 (investment by owner less drawings by owner). At this time, you need not be concerned with how these amounts are determined. [Chapter 17](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c17.xhtml) will examine the statement of cash flows in detail.

### People, Planet, and Profit Insight

#### Beyond Financial Statements



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

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But many interesting and useful efforts are underway. Throughout this textbook, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to stockholders.

**Why might a company's stockholders be interested in its environmental and social performance? (Go to WileyPLUS for this answer and additional questions.)**

### DO IT! 5 | Financial Statement Items

Presented below is selected information related to Flanagan Company at December 31, 2020. Flanagan reports financial information monthly.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Equipment | $10,000 |  | Utilities Expense | $ 4,000 |
| Cash | 8,000 | Accounts Receivable | 9,000 |
| Service Revenue | 36,000 | Salaries and Wages Expense | 7,000 |
| Rent Expense | 11,000 | Notes Payable | 16,500 |
| Accounts Payable | 2,000 | Owner's Drawings | 5,000 |

* **a.** Determine the total assets of Flanagan Company at December 31, 2020.
* **b.** Determine the net income that Flanagan Company reported for December 2020.
* **c.** Determine the owner's equity of Flanagan Company at December 31, 2020.

### ACTION PLAN

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

#### Solution

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

|  |  |  |
| --- | --- | --- |
| Revenues |  |  |
| Service revenue |  | $36,000 |
| Expenses |  |  |
| Rent expense | $11,000 |  |
| Salaries and wages expense | 7,000 |  |
| Utilities expense | 4,000 |  |
| Total expenses |  | 22,000 |
| Net income |  | $14,000 |

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

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

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

Related exercise material: [**BE1.10**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0112)**,**[**BE1.11**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0113)**,**[**DO IT! 1.5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0118)**,**[**E1.9**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0142)**,**[**E1.10**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0143)**,**[**E1.11**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0147)**,**[**E1.12**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0148)**,**[**E1.13**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0149)**,**[**E1.14**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0150)**,**[**E1.15**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0153)**,**[**E1.16**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0154)**,**[**E1.17**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-1007)**and**[**E1.18**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-1008)**.**

## Appendix 1A Career Opportunities in Accounting

### LEARNING OBJECTIVE \*6

Explain the career opportunities in accounting.

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

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

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

### Public Accounting

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

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

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

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

### Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Starbucks**, **Alphabet**, or **PepsiCo**. In **managerial (or private) 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, and tax planning and preparation. You might also be a member of your company's internal audit team. In response to SOX, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on increased importance.

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

### Governmental Accounting

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

### Forensic Accounting

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

### “Show Me the Money”

How much can a new accountant make? Take a look at the average salaries for college graduates in public and private accounting listed in [**Illustration 1A.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0012). Keep in mind if you also have a CPA license, you'll make 10–15% more when you start out.

| **Employer** |  | **Jr. Level (0–3 yrs.)** |  | **Sr. Level (4–6 yrs.)** |
| --- | --- | --- | --- | --- |
| Public accounting (large firm) |  | $63,250–$83,250 |  | $78,500–$106,500 |
| Public accounting (small firm) | $51,500–$60,500 | $63,750–$ 81,500 |
| Corporate accounting (large company) | $53,750–$69,500 | $68,750–$ 87,750 |
| Corporate accounting (small company) | $45,000–$59,000 | $57,500–$ 70,000 |

[**ILLUSTRATION 1A.1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0012-a) **Salary estimates for jobs in public and corporate accounting**

[**Illustration 1A.2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0013) offers some examples of upper-level salaries for managers in corporate accounting. Note that geographic region, experience, education, CPA certification, and company size each play a role in determining salary.

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

[**ILLUSTRATION 1A.2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0013-a) **Upper-level management salaries in corporate accounting**

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

## Review and Practice

### Learning Objectives Review

* **1**  **Identify the activities and users associated with accounting.**

Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users. The major users and uses of accounting are as follows. (a) Management uses accounting information to plan, organize, and run the business. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, and labor unions.

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

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

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

* **3**  **State the accounting equation, and define its components.**

The basic accounting equation is:

Assets=Liabilities+Owner's EquityAssets=Liabilities+Owner's Equity

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

The expanded accounting equation is:

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

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

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

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

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

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

* **\*6**  **Explain the career opportunities in accounting.**

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

**Glossary Review**

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

**Accounting information system** The system of collecting and processing transaction data and communicating financial information to decision-makers.

**Assets** Resources a business owns.

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

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

**Basic accounting equation** Assets = Liabilities + Owner's equity.

**Bookkeeping** A part of the accounting process that involves only the recording of economic events.

**Convergence** The process of reducing the differences between U.S. GAAP and IFRS.

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

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

**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.

**Ethics** The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.

**Expanded accounting equation** Assets = Liabilities + Owner's capital − Owner's drawings + Revenues − Expenses.

**Expenses** The cost of assets consumed or services used in the process of generating revenue.

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

**Faithful representation** Numbers and descriptions match what really existed or happened—they are factual.

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

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

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

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

**Historical cost principle** An accounting principle that states that companies should record assets at their cost.

**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.

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

**International Financial Reporting Standards (IFRS)** International accounting standards set by the International Accounting Standards Board (IASB).

**Investments by owner** The assets an owner puts into the business.

**Liabilities** Creditor claims against total assets.

**\*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.

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

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

**Net income** The amount by which revenues exceed expenses.

**Net loss** The amount by which expenses exceed revenues.

**Owner's equity** The ownership claim on total assets.

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

**Partnership** A business owned by two or more persons associated as partners.

**Proprietorship** A business owned by one person.

**\*Public accounting** An area of accounting in which the accountant offers expert service to the general public.

**Relevance** Financial information that is capable of making a difference in a decision.

**Revenues** The increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business.

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

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

**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.

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

**Transactions** The economic events of a business that are recorded by accountants.

### Practice Multiple-Choice Questions

**1.** **(LO**[**1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1000)**)** Which of the following is **not** a step in the accounting process?

1. **a.** Identification.
2. **b.** Economic entity.
3. **c.** Recording.
4. **d.** Communication.

**2.** **(LO**[**1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1000)**)** Which of the following statements about users of accounting information is **incorrect**?

1. **a.** Management is an internal user.
2. **b.** Taxing authorities are external users.
3. **c.** Present creditors are external users.
4. **d.** Regulatory authorities are internal users.

**3.** **(LO**[**2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1001)**)** The historical cost principle states that:

1. **a.** assets should be initially recorded at cost and adjusted when the fair value changes.
2. **b.** activities of an entity are to be kept separate and distinct from its owner.
3. **c.** assets should be recorded at their cost.
4. **d.** only transaction data capable of being expressed in terms of money be included in the accounting records.

**4.** **(LO**[**2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1001)**)** Which of the following statements about basic assumptions is **correct**?

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

**5.** **(LO**[**2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1001)**)** The three types of business entities are:

1. **a.** proprietorships, small businesses, and partnerships.
2. **b.** proprietorships, partnerships, and corporations.
3. **c.** proprietorships, partnerships, and large businesses.
4. **d.** financial, manufacturing, and service companies.

**6.** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Net income will result during a time period when:

1. **a.** assets exceed liabilities.
2. **b.** assets exceed revenues.
3. **c.** expenses exceed revenues.
4. **d.** revenues exceed expenses.

**7.** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** As of December 31, 2020, Kent Company has assets of $3,500 and owner's equity of $2,000. What are the liabilities for Kent Company as of December 31, 2020?

1. **a.** $1,500.
2. **b.** $1,000.
3. **c.** $2,500.
4. **d.** $2,000.

**8.** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Performing services on account will have the following effects on the components of the basic accounting equation:

1. **a.** increase assets and decrease owner's equity.
2. **b.** increase assets and increase owner's equity.
3. **c.** increase assets and increase liabilities.
4. **d.** increase liabilities and increase owner's equity.

**9.** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Which of the following events is **not** recorded in the accounting records?

1. **a.** Equipment is purchased on account.
2. **b.** An employee is terminated.
3. **c.** A cash investment is made into the business.
4. **d.** The owner withdraws cash for personal use.

**10.** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** During 2020, Bruske Company's assets decreased $50,000 and its liabilities decreased $50,000. Its owner's equity therefore:

1. **a.** increased $50,000.
2. **b.** decreased $50,000.
3. **c.** decreased $100,000.
4. **d.** did not change.

**11.** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Payment of an account payable affects the components of the accounting equation in the following way.

1. **a.** Decreases owner's equity and decreases liabilities.
2. **b.** Increases assets and decreases liabilities.
3. **c.** Decreases assets and increases owner's equity.
4. **d.** Decreases assets and decreases liabilities.

**12.** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** Which of the following statements is **false**?

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

**13.** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** On the last day of the period, Alan Cesska Company buys a $900 machine on credit. This transaction will affect the:

1. **a.** income statement only.
2. **b.** balance sheet only.
3. **c.** income statement and owner's equity statement only.
4. **d.** income statement, owner's equity statement, and balance sheet.

**14.** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** The financial statement that reports assets, liabilities, and owner's equity is the:

1. **a.** income statement.
2. **b.** owner's equity statement.
3. **c.** balance sheet.
4. **d.** statement of cash flows.

**\*15.** **(LO**[**6**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1005)**)** Services performed by a public accountant include:

1. **a.** auditing, taxation, and management consulting.
2. **b.** auditing, budgeting, and management consulting.
3. **c.** auditing, budgeting, and cost accounting.
4. **d.** auditing, budgeting, and management consulting.

#### Solutions

[**1.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0010) **b.** Economic entity is not one of the steps in the accounting process. The other choices are true because (a) identification is the first step in the accounting process, (c) recording is the second step in the accounting process, and (d) communication is the third and final step in the accounting process.

[**2.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0011) **d.** Regulatory authorities are external, not internal, users of accounting information. The other choices are true statements.

[**3.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0012) **c.** The historical cost principle states that assets should be recorded at their cost. The other choices are incorrect because (a) the historical cost principle does not say that assets should be adjusted for changes in fair value, (b) describes the economic entity assumption, and (d) describes the monetary unit assumption.

[**4.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0013) **b.** The economic entity assumption states that there should be a particular unit of accountability. The other choices are incorrect because (a) basic assumptions are not the same as accounting principles, (c) the monetary unit assumption allows accounting to measure economic events, and (d) partnerships are economic entities.

[**5.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0014) **b.** Proprietorships, partnerships, and corporations are the three types of business entities. Choices (a) and (c) are incorrect because small and large businesses only denote the sizes of businesses. Choice (d) is incorrect because financial, manufacturing, and service companies are types of businesses, not business entities.

[**6.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0015) **d.** Net income results when revenues exceed expenses. The other choices are incorrect because (a) assets and liabilities are not used in the computation of net income; (b) revenues, not assets, are included in the computation of net income; and (c) when expenses exceed revenues, a net loss results.

[**7.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0016) **a.** Using a variation of the basic accounting equation, Assets − Owner's equity = Liabilities, $3,500 − $2,000 = $ 1,500. Therefore, choices (b) $1,000, (c) $2,500, and (d) $2,000 are incorrect.

[**8.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0017) **b.** When services are performed on account, assets are increased and owner's equity is increased. The other choices are incorrect because when services are performed on account (a) owner's equity is increased, not decreased; (c) liabilities are not affected; and (d) owner's equity is increased and liabilities are not affected.

[**9.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0018) **b.** If an employee is terminated, this represents an activity of a company, not a business transaction. Assets, liabilities, and owner's equity are not affected. Thus, there is no effect on the accounting equation. The other choices are incorrect because they are all recorded: (a) when equipment is purchased on account, both assets and liabilities increase; (c) when a cash investment is made into a business, both assets and owner's equity increase; and (d) when an owner withdraws cash for personal use, both assets and owner's equity decrease.

[**10.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0019) **d.** In this situation, owner's equity does not change because only assets and liabilities decreased $50,000. Therefore, the other choices are incorrect.

[**11.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0020) **d.** Payment of an account payable results in an equal decrease of assets (cash) and liabilities (accounts payable). The other choices are incorrect because payment of an account payable (a) does not affect owner's equity, (b) does not increase assets, and (c) does not affect owner's equity.

[**12.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0021) **c.** An income statement represents the revenues, expenses, and the resulting net income or net loss for a specific period of time but not the changes in owner's equity. The other choices are true statements.

[**13.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0022) **b.** This transaction will cause assets to increase by $900 and liabilities to increase by $900. The other choices are incorrect because this transaction (a) will have no effect on the income statement, (c) will have no effect on the income statement or the owner's equity statement, and (d) will affect the balance sheet but not the income statement or the owner's equity statement.

[**14.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0023) **c.** The balance sheet is the statement that reports assets, liabilities and owner's equity. The other choices are incorrect because (a) the income statement reports revenues and expenses, (b) the owner's equity statement reports details about owner's equity, and (d) the statement of cash flows reports inflows and outflows of cash.

[**\*15.**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0024) **a.** Auditing, taxation, and management consulting are all services performed by public accountants. The other choices are incorrect because public accountants do not perform budgeting or cost accounting.

### Practice Brief Exercises

**1.** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** At the beginning of the year, Ortiz Company had total assets of $900,000 and total liabilities of $440,000. Answer the following questions.

*Use basic accounting equation*.

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

#### Solution

* + **a.** ($900,000 − $440,000) − $100,000 − $80,000 = $280,000 owner's equity
  + **b.** $900,000 − $100,000 + $200,000 = $1,000,000 total assets
  + **c.** $440,000 − $60,000 + $50,000 = $430,000 total liabilities

**2.** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Presented below are three business transactions. List the letters (a), (b), and (c) with columns for assets, liabilities and owner's equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and owner's equity.

*Determine effect of transactions on basic accounting equation*.

* **a.** Purchased equipment on account.
* **b.** Withdrawal of cash by owner.
* **c.** Paid expenses in cash.

#### Solution

|  |  | **Assets** |  | **Liabilities** |  | **Owner's Equity** |
| --- | --- | --- | --- | --- | --- | --- |
| **a.** |  | + |  | + |  | NE |
| **b.** | − | NE | − |
| **c.** | − | NE | − |

**3.** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Follow the same format as in **Practice Brief Exercise 2**. Determine the effect on assets, liabilities, and owner's equity of the following three transactions.

*Determine effect of transactions on basic accounting equation*.

**a.** Performed accounting services for clients for cash.

**b.** Borrowed cash from a bank on a note payable.

**c.** Paid cash for rent for the month.

#### Solution

|  |  | **Assets** |  | **Liabilities** |  | **Owner's Equity** |
| --- | --- | --- | --- | --- | --- | --- |
| **a.** |  | + |  | NE |  | + |
| **b.** | + | + | NE |
| **c.** | − | NE | − |

**4.** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or owner's equity statement (OE).

*Determine where items appear on financial statements*.

**a.** Owner's capital.

**b.** Cash.

**c.** Salaries and wages expense.

**d.** Service revenue.

**e.** Accounts payable.

#### Solution

|  |  |  |  |
| --- | --- | --- | --- |
| **a.** | Owner's capital OE, BS |  | OE, BS |
| **b.** | Cash | BS |
| **c.** | Salaries and wages expense | IS |
| **d.** | Service revenue | IS |
| **e.** | Accounts payable | BS |

**5.** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Presented below in alphabetical order are balance sheet items for Feagler Company at December 31, 2020. Carole Feagler is the owner of the company. Prepare a balance sheet following the format of [Illustration 1.9](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009).

*Prepare a balance sheet*.

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

#### Solution

| **Feagler Company Balance Sheet December 31, 2020** | |
| --- | --- |
| **Assets** | |
| Cash | $38,000 |
| Accounts receivable | 12,500 |
| Total assets | $50,500 |
| **Liabilities and Owner's Equity** | |
| Liabilities |  |
| Notes payable | $40,000 |
| Owner's equity |  |
| Owner's capital | 10,500 |
| Total liabilities and owner's equity | $50,500 |

### Practice Exercises

**1.** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**,**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Selected transactions for Fabulous Flora Company are listed below.

*Analyze the effect of transactions*.

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

#### Instructions

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

#### Solution

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

**2.** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**,**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Alma's Payroll Services Company entered into the following transactions during May 2020.

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

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

#### Instructions

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

**a.** an increase in assets and a decrease in assets.

**b.** an increase in assets and an increase in owner's equity.

**c.** an increase in assets and an increase in liabilities.

**d.** a decrease in assets and a decrease in owner's equity.

**e.** a decrease in assets and a decrease in liabilities.

**f.** an increase in liabilities and a decrease in owner's equity.

**g.** an increase in owner's equity and a decrease in liabilities.

#### Solution

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

### Practice Problem

**(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**,**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** Joan Robinson opens her own law office on July 1, 2020. During the first month of operations, the following transactions occurred.

*Prepare a tabular presentation and financial statements*.

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

#### Instructions

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

**b.** An icon shown as rectangular bar, which reads text “Financial statement.”Prepare the income statement, owner's equity statement, and balance sheet at July 31, 2020, for Joan Robinson, Attorney.

#### Solution

* **a.**

A table shows summary of eight transactions for Joan Robinson for the month of July. The transaction is displayed in accounting analysis format, which begins with the accounting equation expressed as: Assets equals Liabilities plus Owner’s equity. Asset is shown as a sum of Cash, Accounts receivable, and Equipment while Liabilities is displayed as a sum of Notes payable and Accounts payable. Owner’s equity is expressed as Owner’s capital minus Owner’s drawings plus Revenues minus Expenses. The ten transactions are listed as follows: Transaction numbered (1) shows an increase of $11,000 as Cash under Assets and an increase of $11,000  as Owner’s capital under Owner's equity.  Transaction numbered (2) shows a decrease of 800 as Cash under Assets and a decrease of $800 as Expenses under Owner’s Equity. Transaction numbered (3) shows an increase of $3,000 as Equipment under Assets and an increase of $3,000 as Accounts Payable under Liabilities. Transaction numbered (4) shows a decrease of 1,500 as Cash under Assets and an increase of $1,500 as Revenues under Owner’s Equity.  Transaction numbered (5) shows an increase of 700 as Cash under Assets and an increase of $700 as Notes Payable under Liabilities. Transaction numbered (6) shows an increase of $2,000 as Accounts receivable under Assets and a decrease of 2,000 as Revenues under owner’s equity.  Transaction numbered (7) shows a decrease of 500, a decrease of 300, a decrease of 100 as Cash under Assets, as well as a decrease of 500, a decrease of 300, a decrease of 100 as Expenses under Owner's Equity. Transaction numbered (8) shows a decrease of 1,000 as Cash under Assets and a decrease of 1,000 as Owner’s Drawings under Owner’s Equity.  The total is shown as: Cash ($10,500) plus Accounts receivable ($2,000) plus Equipment ($3,000) equals Notes Payable ($700) plus Accounts payable ($3,000) plus Owner’s capital ($11,000) minus Owner’s drawings ($1,000) plus Revenues ($3,500) minus Expenses ($1,700). The total assets are shown equal to sum of liabilities and owner's equity displayed as $15,500.

* **b.**

| **Joan Robinson, Attorney Income Statement For the Month Ended July 31, 2020** | | | | | | |
| --- | --- | --- | --- | --- | --- | --- |
|  | Revenues |  |  |  |  |  |
| Service revenue |  | $3,500 |
| Expenses |  |  |
| Rent expense | $800 |  |
| Salaries and wages expense | 500 |  |
| Utilities expense | 300 |  |
| Advertising expense | 100 |  |
| Total expenses |  | 1,700 |
| Net income |  | $1,800 |

| **Joan Robinson, Attorney Owner's Equity Statement For the Month Ended July 31, 2020** | | | | | | |
| --- | --- | --- | --- | --- | --- | --- |
|  | Owner's capital, July 1 |  |  |  | $     0 |  |
| Add: Investments | $11,000 |  |
| Net income | 1,800 | 12,800 |
|  |  | 12,800 |
| Less: Drawings |  | 1,000 |
| Owner's capital, July 31 |  | $11,800 |

| **Joan Robinson, Attorney Balance Sheet July 31, 2020** | | | | |
| --- | --- | --- | --- | --- |
|  | **Assets** | | |  |
| Cash |  | $10,500 |
| Accounts receivable | 2,000 |
| Equipment | 3,000 |
| Total assets | $15,500 |
| **Liabilities and Owner's Equity** | | |
| Liabilities |  |  |
| Notes payable | $   700 |
| Accounts payable | 3,000 |
| Total liabilities | 3,700 |
| Owner's equity |  |
| Owner's capital | 11,800 |
| Total liabilities and owner's equity | $15,500 |

## WileyPLUS

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

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

## Questions

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

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

**3.**

**a.** Who are internal users of accounting data?

**b.** How does accounting provide relevant data to these users?

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

**5.** “Bookkeeping and accounting are the same.” Do you agree? Explain.

**6.** Benton Travel Agency purchased land for $90,000 cash on December 10, 2020. At December 31, 2020, the land's value has increased to $92,000. What amount should be reported for land on Benton's balance sheet at December 31, 2020? Explain.

**7.** What is the monetary unit assumption?

**8.** What is the economic entity assumption?

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

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

**11.** What is the basic accounting equation?

**12.**

**a.** Define the terms assets, liabilities, and owner's equity.

**b.** What items affect owner's equity?

**13.** Which of the following items are liabilities of Siebers Jewelry Stores?

1. **a.** Cash.
2. **b.** Accounts payable.
3. **c.** Owner's drawings.
4. **d.** Accounts receivable.
5. **e.** Supplies.
6. **f.** Equipment.
7. **g.** Salaries and wages payable.
8. **h.** Service revenue.
9. **i.** Rent expense.

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

**15.** Are the following events recorded in the accounting records? Explain your answer in each case.

**a.** The owner of the company dies.

**b.** Supplies are purchased on account.

**c.** An employee is fired.

**d.** The owner of the business withdraws cash from the business for personal use.

**16.** Indicate how the following business transactions affect the basic accounting equation.

**a.** Paid cash for janitorial services.

**b.** Purchased equipment for cash.

**c.** Invested cash in the business.

**d.** Paid accounts payable in full.

**17.** Listed below are some items found in the financial statements of Tony Gruber Co. Indicate in which financial statement(s) the following items would appear.

**a.** Service revenue.

**b.** Equipment.

**c.** Advertising expense.

**d.** Accounts receivable.

**e.** Owner's capital.

**f.** Salaries and wages payable.

**18.** In February 2020, Ola Gott invested an additional $12,000 in her business, Gott's Pharmacy, which is organized as a proprietorship. Gott's accountant, Sal Costa, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?

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

**20.** Bayler Enterprises had a capital balance of $186,000 at the beginning of the period. At the end of the accounting period, the capital balance was $189,000.

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

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

**21.** Summarized operations for Bayles Co. for the month of July are as follows.

* Revenues recognized: for cash $20,000; on account $70,000.
* Expenses incurred: for cash $26,000; on account $40,000.

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

**22.** The basic accounting equation is Assets = Liabilities + Owner's equity. Replacing the words in that equation with dollar amounts, what is **Apple**'s accounting equation at September 26, 2015? (*Hint:* Owner's equity is equivalent to shareholders' equity.)

## Brief Exercises

**BE1.1** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Presented below is the basic accounting equation. Determine the missing amounts.

*Use basic accounting equation*.

|  | **Assets** |  | **=** |  | **Liabilities** |  | **+** |  | **Owner's Equity** |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $90,000 |  |  |  | $50,000 |  |  |  | ? |
| **b.** | ? |  | $44,000 |  | $70,000 |
| **c.** | $94,000 |  | ? |  | $53,000 |

**BE1.2** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Given the accounting equation, answer each of the following questions.

*Use basic accounting equation*.

**a.** The liabilities of Berber Company are $120,000 and the owner's equity is $230,000. What is the amount of Weber Company's total assets?

**b.** The total assets of Berber Company are $190,000 and its owner's equity is $89,000. What is the amount of its total liabilities?

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

**BE1.3** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** At the beginning of the year, Gilles Company had total assets of $800,000 and total liabilities of $300,000. Answer the following questions.

*Use basic accounting equation*.

**a.** If total assets increased $150,000 during the year and total liabilities decreased $60,000, what is the amount of owner's equity at the end of the year?

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

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

**BE1.4** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Use the expanded accounting equation to answer each of the following questions.

*Solve expanded accounting equation*.

**a.** The liabilities of Platt Company are $90,000. Owner's capital is $150,000; drawings are $40,000; revenues, $450,000; and expenses, $340,000. What is the amount of Platt Company's total assets?

**b.** The total assets of Sierra Company are $57,000. Owner's capital is $35,000; drawings are $7,000; revenues, $52,000; and expenses, $35,000. What is the amount of the company's total liabilities?

**c.** The total assets of Birch Co. are $660,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Birch Co.'s owner's equity?

**BE1.5** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Indicate whether each of the following items is an asset (A), liability (L), or part of owner's equity (OE).

*Identify assets, liabilities, and owner's equity*.

* \_\_\_\_\_\_\_\_\_\_\_ **a.** Accounts receivable
* \_\_\_\_\_\_\_\_\_\_\_ **b.** Salaries and wages payable
* \_\_\_\_\_\_\_\_\_\_\_ **c.** Equipment
* \_\_\_\_\_\_\_\_\_\_\_ **d.** Supplies
* \_\_\_\_\_\_\_\_\_\_\_ **e.** Owner's capital
* \_\_\_\_\_\_\_\_\_\_\_ **f.** Notes payable

**BE1.6** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Classify each of the following items as owner's drawings (D), revenue (R), or expense (E).

*Classify items affecting owner's equity*.

* \_\_\_\_\_\_\_\_\_\_\_ **a.** Advertising expense
* \_\_\_\_\_\_\_\_\_\_\_ **b.** Service revenue
* \_\_\_\_\_\_\_\_\_\_\_ **c.** Insurance expense
* \_\_\_\_\_\_\_\_\_\_\_ **d.** Salaries and wages expense
* \_\_\_\_\_\_\_\_\_\_\_ **e.** Owner's drawings
* \_\_\_\_\_\_\_\_\_\_\_ **f.** Rent revenue
* \_\_\_\_\_\_\_\_\_\_\_ **g.** Utilities expense

**BE1.7** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Presented below are three business transactions. On a sheet of paper, list the letters (a), (b), and (c) with columns for assets, liabilities, and owner's equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and owner's equity.

*Determine effect of transactions on basic accounting equation*.

**a.** Purchased supplies on account.

**b.** Received cash for performing a service.

**c.** Paid expenses in cash.

**BE1.8** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Follow the same format as in [BE1.7](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0102). Determine the effect on assets, liabilities, and owner's equity of the following three transactions.

*Determine effect of transactions on basic accounting equation*.

**a.** Invested cash in the business.

**b.** Withdrawal of cash by owner.

**c.** Received cash from a customer who had previously been billed for services performed.

**BE1.9** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Presented below are three transactions. Mark each transaction as affecting owner's investment (I), owner's drawings (D), revenue (R), expense (E), or not affecting owner's equity (NOE).

*Determine effect of transactions on basic owner's equity*.

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

**BE1.10** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” In alphabetical order below are balance sheet items for Smyth Company at December 31, 2020. Kathy Smyth is the owner of Smyth Company. Prepare a balance sheet, following the format of [Illustration 1.9](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0009).

*Prepare a balance sheet*.

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

**BE1.11** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Indicate whether the following items would appear on the income statement (IS), balance sheet (BS), or owner's equity statement (OE).

*Determine where items appear on financial statements*.

* \_\_\_\_\_\_\_\_\_\_\_ **a.** Notes payable
* \_\_\_\_\_\_\_\_\_\_\_ **b.** Advertising expense
* \_\_\_\_\_\_\_\_\_\_\_ **c.** Owner's capital
* \_\_\_\_\_\_\_\_\_\_\_ **d.** Cash
* \_\_\_\_\_\_\_\_\_\_\_ **e.** Service revenue

## DO IT! Exercises

**DO IT! 1.1** **(LO**[**1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1000)**)** Indicate whether each of the five statements presented below is true or false.

*Review basic concepts*.

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

**DO IT! 1.2** **(LO**[**2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1001)**)** Indicate whether each of the five statements presented below is true or false.

*Identify building blocks of accounting*.

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

**DO IT! 1.3** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Classify the following items as investment by owner (I), owner's drawings (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases owner's equity.

*Evaluate effects of transactions on owner's equity*.

* **1.** Drawings.
* **2.** Rent revenue.
* **3.** Advertising expense.
* **4.** Owner puts personal assets into the business.

**DO IT! 1.4** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Transactions made by A. Marti and Co., a law firm, for the month of March are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in [Illustration 1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-fig-0008).

*Prepare tabular analysis*.

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

**DO IT! 1.5** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** Presented below is selected information related to Kirby Company at December 31, 2020. Kirby reports financial information monthly.

*Determine specific amounts on the financial statements*.

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

**a.** Determine the total assets of Kirby Company at December 31, 2020.

**b.** Determine the net income that Kirby Company reported for December 2020.

**c.** Determine the owner's equity of Kirby Company at December 31, 2020.

## Exercises

**E1.1** **(LO**[**1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1000)**)** Genesis Company performs the following accounting tasks during the year.

*Classify the three activities of accounting*.

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

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

#### Instructions

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

**E1.2** **(LO**[**1**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1000)**)**

*Identify users of accounting information*.

**a.** The following are users of financial statements.

* \_\_\_\_\_\_\_\_\_\_ Customers
* \_\_\_\_\_\_\_\_\_\_ Internal Revenue Service
* \_\_\_\_\_\_\_\_\_\_ Labor unions
* \_\_\_\_\_\_\_\_\_\_ Marketing manager
* \_\_\_\_\_\_\_\_\_\_ Production supervisor
* \_\_\_\_\_\_\_\_\_\_ Securities and Exchange Commission
* \_\_\_\_\_\_\_\_\_\_ Store manager
* \_\_\_\_\_\_\_\_\_\_ Suppliers
* \_\_\_\_\_\_\_\_\_\_ Vice president of finance

#### Instructions

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

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

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

#### Instructions

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

**E1.3** **(LO**[**2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1001)**)** Angela Duffy, president of Duffy Company, has instructed Jana Barth, the head of the accounting department for Duffy Company, to report the company's land in the company's accounting reports at its fair value of $170,000 instead of its cost of $100,000. Duffy says, “Showing the land at $170,000 will make our company look like a better investment when we try to attract new investors next month.”

*Discuss ethics and the historical cost principle*.

#### Instructions

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

**E1.4** **(LO**[**2**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1001)**)** The following situations involve accounting principles and assumptions.

*Use accounting concepts*.

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

#### Instructions

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

**E1.5** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**)** Diehl Cleaners has the following balance sheet items.

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

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

#### Instructions

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

**E1.6** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Selected transactions for Poway Landscaping Company are listed below.

*Analyze the effect of transactions*.

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

#### Instructions

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

**E1.7** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** Falske Computer Timeshare Company entered into the following transactions during May 2020.

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

* **1.** Purchased computers for $20,000 from Digital Equipment on account.
* **2.** Paid $4,000 cash for May rent on storage space.
* **3.** Received $17,000 cash from customers for contracts billed in April.
* **4.** Performed computer services for Viking Construction Company for $4,000 cash.
* **5.** Paid Tri-State Power Co. $11,000 cash for energy usage in May.
* **6.** Falske invested an additional $29,000 in the business.
* **7.** Paid Digital Equipment for the computers purchased in (1) above.
* **8.** Incurred advertising expense for May of $1,200 on account.

#### Instructions

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

**a.** An increase in assets and a decrease in assets.

**b.** An increase in assets and an increase in owner's equity.

**c.** An increase in assets and an increase in liabilities.

**d.** A decrease in assets and a decrease in owner's equity.

**e.** A decrease in assets and a decrease in liabilities.

**f.** An increase in liabilities and a decrease in owner's equity.

**g.** An increase in owner's equity and a decrease in liabilities.

**E1.8** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** A rectangular text box reads 'Writing'. An analysis of the transactions made by Peat Deloitte & Co., a certified public accounting firm, for the month of August is shown below. The expenses were $560 for rent, $4,800 for salaries and wages, and $400 for utilities.

*Analyze transactions and compute net income*.

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

#### Instructions

**a.** Describe each transaction that occurred for the month.

**b.** Determine how much owner's equity increased for the month.

**c.** Compute the amount of net income for the month.

**E1.9** An icon shown as rectangular bar, which reads text “Financial statement.” **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An analysis of transactions for Peat DeLoitte & Co. was presented in [E1.8](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-ex-0138).

*Prepare financial statements*.

#### Instructions

Prepare an income statement and an owner's equity statement for August and a balance sheet at August 31, 2020. Assume that August is the company's first month of business.

**E1.10** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** Hawke Company had the following assets and liabilities on the dates indicated.

*Determine net income (or loss)*.

| **December 31** |  | **Total Assets** |  | **Total Liabilities** |
| --- | --- | --- | --- | --- |
| 2019 |  | $400,000 |  | $250,000 |
| 2020 | $460,000 | $300,000 |
| 2021 | $590,000 | $400,000 |

Hawke began business on January 1, 2019, with an investment of $100,000.

#### Instructions

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

**a.** 2019, assuming Hawke's drawings were $12,000 for the year.

**b.** 2020, assuming Hawke made an additional investment of $34,000 and had no drawings in 2020.

**c.** 2021, assuming Hawke made an additional investment of $12,000 and had drawings of $25,000 in 2021.

**E1.11** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** Two items are omitted from each of the following summaries of balance sheet and income statement data for two proprietorships for the year 2020, Greene's Goods and Solar Enterprises.

*Analyze financial statements items*.

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

#### Instructions

Determine the missing amounts.

**E1.12** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” The following information relates to Fleete Co. for the year 2020.

*Prepare income statement and owner's equity statement*.

|  |  |  |
| --- | --- | --- |
| Owner's capital, January 1, 2020 |  | $42,000 |
| Owner's drawings during 2020 | 6,000 |
| Service revenue | 63,600 |
| Salaries and wages expense | 30,200 |
| Advertising expense | $ 1,800 |
| Rent expense | 10,400 |
| Utilities expense | 3,100 |

#### Instructions

After analyzing the data, prepare an income statement and an owner's equity statement for the year ending December 31, 2020.

**E1.13** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Abby Roland is the bookkeeper for Cheng Company. Abby has been trying to determine the correct balance sheet for Cheng Company. Cheng's balance sheet is shown below.

*Correct an incorrectly prepared balance sheet*.

| **Cheng Company Balance Sheet December 31, 2020** | | | | | | |
| --- | --- | --- | --- | --- | --- | --- |
| **Assets** | | |  | **Liabilities** | | |
| Cash |  | $15,000 |  | Accounts payable |  | $21,000 |
| Supplies | 8,000 | Accounts receivable | (6,500) |
| Equipment | 46,000 | Owner's capital | 67,500 |
| Owner's drawings | 13,000 | Total liabilities and    owner's equity | $82,000 |
| Total assets | $82,000 |

#### Instructions

Prepare a correct balance sheet.

**E1.14** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Saira Morrow is the sole owner of Buena Vista Park, a public camping ground near the Crater Lake National Recreation Area. Saira has compiled the following financial information as of December 31, 2020.

*Compute net income and prepare a balance sheet*.

|  |  |  |
| --- | --- | --- |
| Revenues during 2020—camping fees |  | $140,000 |
| Revenues during 2020—general store | 65,000 |
| Accounts payable | 11,000 |
| Cash on hand | 23,000 |
| Original cost of equipment | 115,500 |
| Fair value of equipment | $140,000 |
| Notes payable | 60,000 |
| Expenses during 2020 | 160,000 |
| Accounts receivable | 17,500 |

#### Instructions

**a.** Determine Saira Morrow's net income from Buena Vista Park for 2020.

**b.** Prepare a balance sheet for Buena Vista Park as of December 31, 2020.

**E1.15** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Presented below is financial information related to the 2020 operations of Sea Legs Cruise Company.

*Prepare an income statement*.

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

#### Instructions

Prepare the 2020 income statement for Sea Legs Cruise Company.

**E1.16** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” Presented below is information related to the sole proprietorship of Helen Archer, attorney.

*Prepare an owner's equity statement*.

|  |  |  |
| --- | --- | --- |
| Legal service revenue—2020 |  | $330,000 |
| Total expenses—2020 | 211,000 |
| Assets, January 1, 2020 | 98,000 |
| Liabilities, January 1, 2020 | 62,000 |
| Assets, December 31, 2020 | 168,000 |
| Liabilities, December 31, 2020 | 100,000 |
| Drawings—2020 | ? |

#### Instructions

Prepare the 2020 owner's equity statement for Helen Archer's legal practice.

**E1.17** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” This information is for Paulo Company for the year ended December 31, 2020.

*Prepare a cash flow statement*.

|  |  |  |
| --- | --- | --- |
| Cash received from revenues from customers |  | $600,000 |
| Cash received from investment by owner | 280,000 |
| Cash paid for new equipment | 115,000 |
| Cash drawings by owner paid | 18,000 |
| Cash paid for expenses | 430,000 |
| Cash balance 1/1/20 | 30,000 |

#### Instructions

Prepare the 2020 statement of cash flows for Paulo Company.

**E1.18** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. Operating activities are the types of activities the company performs to generate profits. Investing activities include the purchase of long-lived assets such as equipment or the purchase of investment securities. Financing activities are borrowing money, investment by owner, and cash drawings by owner.

*Identify cash flow activities*.

Presented below are the following transactions.

* **1.** Owner invested $20,000 cash.
* **2.** Issued note payable for $12,000 cash.
* **3.** Purchased office equipment for $11,000 cash.
* **4.** Received $15,000 cash for services performed.
* **5.** Paid $1,000 cash for rent.
* **6.** Paid $600 cash drawings to owner.
* **7.** Paid $5,700 cash for salaries.

#### Instructions

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

## Problems: Set A

**P1.1A** **(LO**[**3**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1002)**,**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**)** An icon shows a circle containing a rightward arrow, with a rectangular text box on its right reading, 'Excel.' On April 1, Julie Spengel established Spengel's Travel Agency. The following transactions were completed during the month.

*Analyze transactions and compute net income*.

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

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

#### Instructions

**a.** Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Owner's Capital, Owner's Drawings, Revenues, and Expenses.

**a. Total assets $20,800**

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

**b. Net income $6,200**

**P1.2A** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**,**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shows a circle containing a rightward arrow, with a rectangular text box on its right reading, 'Excel.' An icon shown as rectangular bar, which reads text “Financial statement.” Sonya Jared opened a law office on July 1, 2020. On July 31, the balance sheet showed Cash $5,000, Accounts Receivable $1,500, Supplies $500, Equipment $6,000, Accounts Payable $4,200, and Owner's Capital $8,800. During August, the following transactions occurred.

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

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

#### Instructions

**a.** Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Owner's Capital − Owner's Drawings + Revenues − Expenses.

**a. Total assets $16,500**

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

**b. Net income $3,130**

**Ending capital $11,230**

**P1.3A** **(LO**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** An icon shown as rectangular bar, which reads text “Financial statement.” On June 1, Cindy Godfrey started Divine Designs Co., a company that provides craft opportunities, by investing $12,000 cash in the business. Following are the assets and liabilities of the company at June 30 and the revenues and expenses for the month of June.

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

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

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

#### Instructions

**a.** Prepare an income statement and owner's equity statement for the month of June and a balance sheet at June 30, 2020.

**a. Net income $4,050**

**Owner's equity $14,750**

**Total assets $24,950**

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

**b. Owner's equity $15,500**

**P1.4A** An icon shown as rectangular bar, which reads text “Financial statement.” **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**,**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** Maisie Taft started her own consulting firm, Maisie Consulting, on May 1, 2020. The following transactions occurred during the month of May.

*Analyze transactions and prepare financial statements*.

|  |  |  |  |
| --- | --- | --- | --- |
| May | 1 |  | Maisie invested $7,000 cash in the business. |
|  | 2 | Paid $900 for office rent for the month. |
|  | 3 | Purchased $800 of supplies on account. |
|  | 5 | Paid $125 to advertise in the *County News*. |
|  | 9 | Received $4,000 cash for services performed. |
|  | 12 | Withdrew $1,000 cash for personal use. |
|  | 15 | Performed $6,400 of services on account. |
|  | 17 | Paid $2,500 for employee salaries. |
|  | 20 | Made a partial payment of $600 for the supplies purchased on account on May 3. |
|  | 23 | Received a cash payment of $4,000 for services performed on account on May 15. |
|  | 26 | Borrowed $5,000 from the bank on a note payable. |
|  | 29 | Purchased equipment for $4,200 on account. |
|  | 30 | Paid $275 for utilities. |

**Instructions**

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

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

**a. Total assets $22,000**

**b.** Prepare an income statement for the month of May.

**b. Net income $6,600**

**c.** Prepare a balance sheet at May 31, 2020.

**c. Cash $14,600**

**P1.5A** **(LO**[**4**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1003)**,**[**5**](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-feafxd-1004)**)** A rectangular text box reads 'Writing'. An icon shown as rectangular bar, which reads text “Financial statement.” Financial statement information about four different companies is as follows.

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

|  |  | **Alpha Company** |  | **Beta Company** |  | **Psi Company** |  | **Omega Company** |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| January 1, 2020 |  |  |  |  |  |  |  |  |
| Assets | $ 80,000 | $ 90,000 | (g) | $150,000 |
| Liabilities | 41,000 | (d) | 80,000 | (j) |
| Owner's equity | (a) | 40,000 | 49,000 | 90,000 |
| December 31, 2020 |  |  |  |  |
| Assets | (b) | 112,000 | 170,000 | (k) |
| Liabilities | 60,000 | 72,000 | (h) | 100,000 |
| Owner's equity | 50,000 | (e) | 82,000 | 151,000 |
| Owner's equity changes in year |  |  |  |  |
| Additional investment | (c) | 8,000 | 10,000 | 15,000 |
| Drawings | 15,000 | (f) | 12,000 | 10,000 |
| Total revenues | 350,000 | 410,000 | (i) | 500,000 |
| Total expenses | 333,000 | 385,000 | 350,000 | (l) |

**Instructions**

**a.** Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets − Liabilities = Owner's equity = $ 39,000.)

**b.** Prepare the owner's equity statement for Alpha Company.

**c.** Write a memorandum explaining the sequence for preparing financial statements and the interrelationship of the owner's equity statement to the income statement and balance sheet.

**Continuing Case**

***The Cookie Creations case starts in this chapter and continues through Chapter***[***18***](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c18.xhtml)***. The business begins as a sole proprietorship and then evolves into a partnership and finally a corporation. You also can find this case in WileyPLUS*.**

**Cookie Creations**

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



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

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

**Instructions**

**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 owner's 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?

**Ethics Case**

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

**Instructions**

**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?

**Expand Your Critical Thinking**

**Financial Reporting Problem: Apple Inc.**

**CT1.1** The financial statements of **Apple Inc.** for 2015 are presented in [Appendix A](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/a01.xhtml). The complete annual report, including the notes to the financial statements, is available at the company's website.

**Instructions**

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

**a.** What were Apple's total assets at September 26, 2015? At September 27, 2014?

**b.** How much cash (and cash equivalents) did Apple have on September 26, 2015?

**c.** What amount of accounts payable did Apple report on September 26, 2015? On September 27, 2014?

**d.** What were Apple's net sales in 2013? In 2014? In 2015?

**e.** What is the amount of the change in Apple's net income from 2014 to 2015?

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

**CT1.2** **PepsiCo, Inc.**'s financial statements are presented in [Appendix B](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/a02.xhtml). Financial statements of **The Coca-Cola Company** are presented in [Appendix C](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/a03.xhtml). The complete annual reports of PepsiCo and Coca-Cola, including the notes to the financial statements, are available at each company's respective website.

**Instructions**

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

**1.** Total assets at December 26, 2015, for PepsiCo and for Coca-Cola at December 31, 2015.

**2.** Accounts (notes) receivable, net at December 26, 2015, for PepsiCo and at December 31, 2015, for Coca-Cola.

**3.** Net revenues for year ended in 2015.

**4.** Net income for year ended in 2015.

**b.** What conclusions concerning the two companies can be drawn from these data?

**Comparative Analysis Problem: Amazon.com, Inc. vs. Wal-Mart Stores, Inc.**

**CT1.3** **Amazon.com, Inc.**'s financial statements are presented in [Appendix D](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/a04.xhtml). Financial statements of **Wal-Mart Stores, Inc.** are presented in [Appendix E](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/a05.xhtml). The complete annual reports of Amazon and Wal-Mart, including the notes to the financial statements, are available at each company's respective website.

**Instructions**

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

**1.** Total assets at December 31, 2015, for Amazon and for Wal-Mart at January 31, 2016.

**2.** Receivables (net) at December 31, 2015, for Amazon and for Wal-Mart at January 31, 2016.

**3.** Net sales (product only) for year ended in 2015 (2016 for Wal-Mart).

**4.** Net income for the year ended in 2015 (2016 for Wal-Mart).

**b.** What conclusions concerning these two companies can be drawn from these data?

**Real-World Focus**

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

**Instructions**

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

**a.** What are the four skill sets that are useful for success in accounting?

**b.** Why are these skill sets useful for a successful accounting career?

**Decision-Making Across the Organization**

**CT1.5** Anya and Nick Ramon, local golf stars, opened the Chip-Shot Driving Range on March 1, 2020, by investing $25,000 of their cash savings in the business. A caddy shack was constructed for cash at a cost of $8,000, and $800 was spent on golf balls and golf clubs. The Ramons leased five acres of land at a cost of $1,000 per month and paid the first month's rent. During the first month, advertising costs totaled $750, of which $100 was unpaid at March 31, and $400 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, Anya and Nick withdrew a total of $1,000 in cash for personal living expenses. A $120 utility bill was received on March 31 but was not paid. On March 31, the balance in the company's bank account was $18,900.

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

#### Instructions

With the class divided into groups, answer the following.

**a.** How could the Ramons have concluded that the business operated at a loss of $6,100? Was this a valid basis on which to determine net income?

**b.** How could the Ramons have concluded that the business operated at a net income of $2,480? (*Hint:* Prepare a balance sheet at March 31.) Was this a valid basis on which to determine net income?

**c.** Without preparing an income statement, determine the actual net income for March.

**d.** What was the revenue recognized in March?

### Communication Activity

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

| **New Hampshire Company Balance Sheet For the Month Ended December 31, 2020** | | | | | | | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Assets** | | |  | **Liabilities** | | |  |
|  | Equipment |  | $25,500 |  | Owner's capital |  | $26,000 |  |
| Cash | 9,000 | Accounts receivable | (5,000) |
| Supplies | 3,000 | Owner's drawings | (2,000) |
| Accounts payable | (8,000) | Notes payable | 10,500 |
|  | $29,500 |  | $29,500 |

#### Instructions

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

### All About You

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

#### Instructions

Provide responses for each of the following questions.

**a.** Discuss whether you think each of the following actions (adapted from the FAFSA website) to increase the chances of receiving financial aid is ethical.

**1.** Spend the student's assets and income first, before spending parents' assets and income.

**2.** Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.

**3.** State that a truly financially dependent child is independent.

**4.** Have a parent take an unpaid leave of absence for long enough to get below the “threshold” level of income.

**b.** What are some reasons why a **company** might want to overstate its earnings?

**c.** What are some reasons why a **company** might want to understate its earnings?

**d.** Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

### Considering People, Planet, and Profit

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

#### Instructions

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

### FASB Codification Activity

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

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

#### Instructions

Academic access to the FASB Codification is available through university subscriptions, obtained from the American Accounting Association, for an annual fee of $150. This subscription covers an unlimited number of students within a single institution. Once this access has been obtained by your school, you should log in and familiarize yourself with the resources that are accessible at the FASB Codification site.

## A Look at IFRS

### LEARNING OBJECTIVE 7

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

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

* **Multinational corporations.** Today's companies view the entire world as their market. For example, **Coca-Cola**, **Intel**, and **McDonald's** generate more than 50% of their sales outside the United States. Many foreign companies, such as **Toyota**, **Nestlé**, and **Sony**, find their largest market to be the United States.
* **Mergers and acquisitions.** The mergers between **Fiat/Chrysler** and **Vodafone/Mannesmann** suggest that we will see even more such business combinations of companies from different countries in the future.
* **Information technology.** As communication barriers continue to topple through advances in technology, companies and individuals in different countries and markets are becoming more comfortable buying and selling goods and services from one another.
* **Financial markets.** Financial markets are of international significance today. Whether it is currency, equity securities (stocks), bonds, or derivatives, there are active markets throughout the world trading these types of instruments.

### Key Points

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

#### Similarities

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

#### Differences

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

### 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.

## IFRS Practice

### IFRS Self-Test Questions

**1.** Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?

1. **a.** Mergers and acquisition activity.
2. **b.** Financial markets.
3. **c.** Multinational corporations.
4. **d.** GAAP is widely considered to be a superior reporting system.

**2.** The Sarbanes-Oxley Act determines:

1. **a.** international tax regulations.
2. **b.** internal control standards as enforced by the IASB.
3. **c.** internal control standards of U.S. publicly traded companies.
4. **d.** U.S. tax regulations.

**3.** IFRS is considered to be more:

1. **a.** principles-based and less rules-based than GAAP.
2. **b.** rules-based and less principles-based than GAAP.
3. **c.** detailed than GAAP.
4. **d.** None of the above.

### IFRS Exercises

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

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

### International Financial Reporting Problem: Louis Vuitton

**IFRS1.3** The financial statements of **Louis Vuitton** are presented in [Appendix F](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/a06.xhtml). The complete annual report, including the notes to its financial statements, is available at the company's website.

#### Instructions

Visit Louis Vuitton's corporate website and answer the following questions from the company's 2015 annual report.

**a.** What accounting firm performed the audit of Louis Vuitton's financial statements?

**b.** What is the address of the company's corporate headquarters?

**c.** What is the company's reporting currency?

#### Answers to IFRS Self-Test Questions

**1.** d **2.** c **3.** a

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[1](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-note-0001-a) The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

[2](https://jigsaw.vitalsource.com/books/9781119411017/epub/OPS/c01.xhtml?create=true&favre=brett#c01-note-0003-a) The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica*, *Geometria*, *Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.