ACCOUNTING PRINCIPLES

THIRTEENTH EDITION

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Accounting Principles

Thirteenth Edition

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* Available in WileyPLUS and Wiley Custom.

From the Authors

Dear Student,

WHY THIS COURSE? Remember your biology course in high school? Did you have one of those "invisible man" models (or maybe something more high-tech than that) that gave you the opportunity to look "inside" the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization. An accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like **Apple** or **Starbucks** or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.

"Whether you are looking at a large multinational company like **Apple** or **Starbucks** or a single-owner software consulting business or coffee shop, knowing the fundamentals of accounting will help you understand what is happening."

WHY THIS TEXT? Your instructor has chosen this text for you because of the authors' trusted reputation. The authors have worked hard to write a text that is engaging, timely, and accurate.

HOW TO SUCCEED? We've asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: "Do the homework." This is one course where doing is learning. The more time you spend on the homework assignments—using the various tools that this text provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting. Besides the text itself, WileyPLUS also offers various support resources.

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

Jerry J. Weygandt
Paul D. Kimmel
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Author Commitment

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Accounting Principles, *Thirteenth Edition*, provides a simple and practical introduction to the fundamentals of accounting. It explains the concepts you need to know. This edition continues this approach by offering even more explanations, illustrations, and homework problems to help students get a firm understanding of the accounting cycle.

DO IT! Exercises

DO IT! Exercises in the body of the text prompt students to stop and review key concepts. They outline the Action Plan necessary to complete the exercise as well as show a detailed solution.

DO IT! 3 | Correcting Entries

Sanchez Company discovered the following errors made in January 2020.

1. A payment of Salaries and Wages Expense of $600 was debited to Supplies and credited to Cash, both for $600.
2. A collection of $3,000 from a client on account was debited to Cash $200 and credited to Service Revenue $200.
3. The purchase of supplies on account for $860 was debited to Supplies $680 and credited to Accounts Payable $680.

Correct the errors without reversing the incorrect entry.

ACTION PLAN

- Compare the incorrect entry with correct entry.
- After comparison, make an entry to correct the accounts.

Solution

1. Salaries and Wages Expense	600	
Supplies		600
2. Service Revenue	200	
Cash	2,800	
Accounts Receivable		3,000

Review and Practice

Each chapter concludes with a Review and Practice section which includes a review of learning objectives, key terms glossary, practice multiple-choice questions with annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with a solution.

Practice Brief Exercises

Prepare the current assets section of a balance sheet.

3. (LO 4) **Financial Statement** The balance sheet debit column of the worksheet for Miguel Company includes the following accounts: Accounts Receivable $25,000, Prepaid Insurance $7,000, Cash $8,000, Supplies $11,000, and Stock Investments (short-term) $14,000. Prepare the current assets section of the balance sheet, listing the accounts in proper sequence.

Solution

3.

Miguel Company
Partial Balance Sheet

Current assets	
Cash	$ 8,000
Stock investments	14,000
Accounts receivable	25,000
Supplies	11,000
Prepaid insurance	7,000
Total current assets	$65,000

Infographic Learning

Over half of the text is visual, providing students alternative ways of learning about accounting. In addition, a new interior design promotes accessibility.

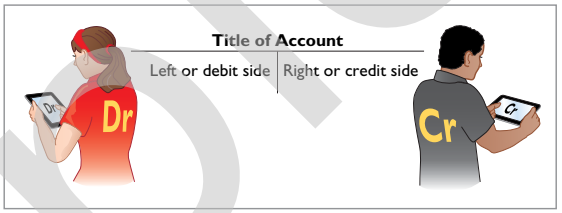

ILLUSTRATION 2.1
Basic form of account

Real-World Decision-Making

Real-world examples that illustrate interesting situations in companies and how accounting information is used are integrated throughout the text, such as in the opening Feature Story as well as the Insight boxes.

People, Planet, and Profit Insight

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Regaining Goodwill

After falling to unforeseen lows amidst scandals, recalls, and economic crises, the American public's positive perception of the reputation of corporate America is on the rise. Overall corporate reputation is experiencing rehabilitation as the American public gives high marks overall to corporate America, specific industries, and the largest number of individual companies in a dozen years. This is according to the findings of a *Harris Interactive RQ Study,* which measures the reputations of the 60 most visible companies in the United States.

The survey focuses on six reputational dimensions that influence reputation and consumer behavior. Four of these dimensions, along with the five corporations that ranked highest within each, are as follows.

- **Social Responsibility**: (1) Whole Foods Market, (2) Johnson & Johnson, (3) Google, (4) The Walt Disney Company, (5) Procter & Gamble Co.
- **Emotional Appeal**: (1) Johnson & Johnson, (2) Amazon.com, (3) UPS, (4) General Mills, (5) Kraft Foods
- **Financial Performance**: (1) Google, (2) Berkshire Hathaway, (3) Apple, (4) Intel, (5) The Walt Disney Company
- **Products and Services**: (1) Intel Corporation, (2) 3M Company, (3) Johnson & Johnson, (4) Google, (5) Procter & Gamble Co.

Source: www.harrisinteractive.com.

Name two industries today which are probably rated low on the reputational characteristics of "being trusted" and "having high ethical standards." (Go to WileyPLUS for this answer and additional questions.)

Additional Guidance

Throughout the text, marginal notes, such as **Helpful Hints**, **Alternative Terminology**, and **Ethics Notes**, are provided as additional guidance. In addition, more than 100 new solution walkthrough videos are now available in WileyPLUS.

Correcting Entries—An Avoidable Step

Unfortunately, errors may occur in the recording process. Companies should correct errors, **as soon as they discover them**, by journalizing and posting **correcting entries**. If the accounting records are free of errors, no correcting entries are needed.

You should recognize several differences between correcting entries and adjusting entries. First, adjusting entries are an integral part of the accounting cycle. Correcting entries, on the other hand, are unnecessary if the records are error-free. Second, companies journalize and post adjustments **only at the end of an accounting period**. In contrast, companies make correcting entries **whenever they discover an error** (see **Ethics Note**). Finally, adjusting entries always affect at least one balance sheet account and one income statement account. In

ETHICS NOTE

When companies find errors in previously released income statements, they restate those numbers. Perhaps because of the increased scrutiny caused by Sarbanes-Oxley, in a recent year companies filed a record 1,195 restatements

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CHAPTER 1

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Accounting in Action

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

Chapter Preview

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

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

Feature Story

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" Well, consider this quote from Harold Geneen, the former chairman of **IT&T**: "To be good at your business, you have to know the numbers—cold." In business, accounting and financial statements are the means for communicating the numbers. If you don't know how to read financial statements, you can't really know your business.

Knowing the numbers is sometimes even a matter of corporate survival. Consider the story of **Columbia Sportswear Company**, headquartered in Portland, Oregon. Gert Boyle's family fled Nazi Germany when she was 13 years old and then purchased a small hat company in Oregon, Columbia Hat

Company. In 1971, Gert's husband, who was then running the company, died suddenly of a heart attack. The company was in the midst of an aggressive expansion, which had taken its sales above $1 million for the first time but which had also left the company financially stressed. Gert took over the small, struggling company with help from her son Tim, who was then a senior at the University of Oregon. Somehow, they kept the company afloat. Today, Columbia has more than 4,000 employees and annual sales in excess of $1 billion. Its brands include Columbia, Mountain Hardwear, Sorel, and Montrail. Gert still heads up the Board of Directors, and Tim is the company's President and CEO.

Columbia doesn't just focus on financial success. The company is very committed to corporate, social, and environmental responsibility. For example, several of its factories have participated in a project to increase health awareness of female factory workers in developing countries. Columbia was also a founding member of the Sustainable Apparel Coalition, which is a group that strives to reduce the environmental and social impact of the apparel industry. In addition, it monitors all of the independent factories that produce its products to ensure that they comply with the company's Standards of Manufacturing Practices. These standards address issues including forced labor, child labor, harassment, wages and benefits, health and safety, and the environment.

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

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

Chapter Outline

LEARNING OBJECTIVES

LO 1 Identify the activities and users associated with accounting.	• Three activities • Who uses accounting data	**DO IT! 1** Basic Concepts
LO 2 Explain the building blocks of accounting: ethics, principles, and assumptions.	• Ethics • GAAP • Measurement principles • Assumptions	**DO IT! 2** Building Blocks of Accounting
LO 3 State the accounting equation, and define its components.	• Assets • Liabilities • Owner's equity	**DO IT! 3** Owner's Equity Effects
LO 4 Analyze the effects of business transactions on the accounting equation.	• Accounting transactions • Transaction analysis • Summary of transactions	**DO IT! 4** Tabular Analysis
LO 5 Describe the four financial statements and how they are prepared.	• Income statement • Owner's equity statement • Balance sheet • Statement of cash flows	**DO IT! 5** Financial Statement Items

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Visit WileyPLUS with ORION for additional tutorials and practice opportunities.

Accounting Activities and Users

LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

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

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

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

Three Activities

As a starting point to the accounting process, a company **identifies** the **economic events relevant to its business**. Examples of economic events are the sale of snack chips by **PepsiCo**, the provision of 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.

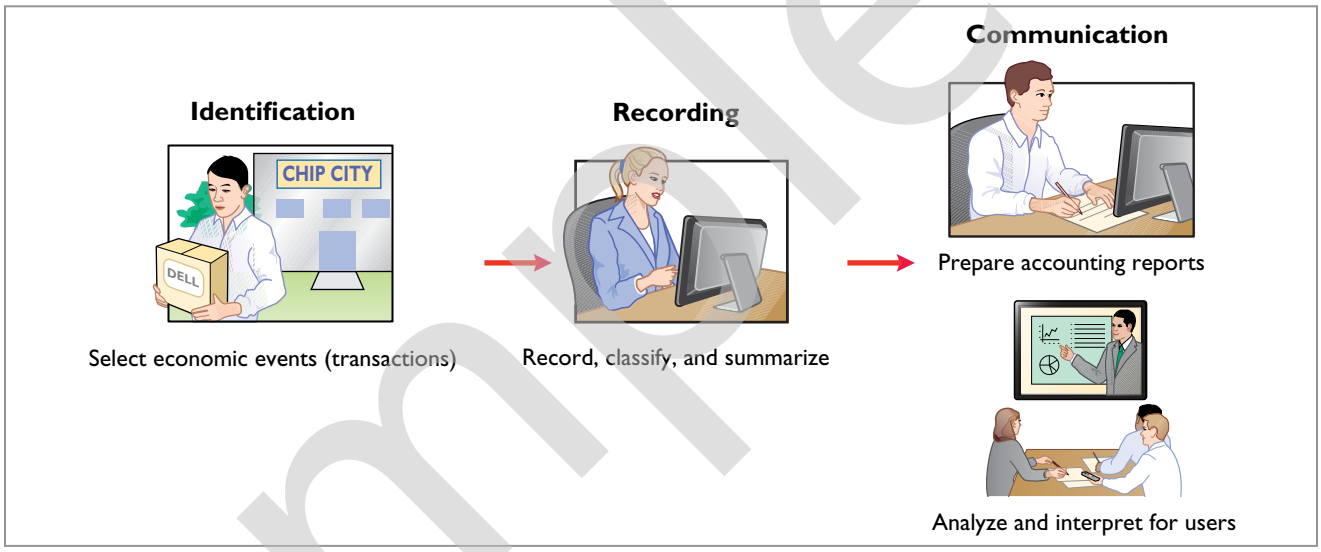
Finally, PepsiCo **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**. To make the reported financial information meaningful, PepsiCo reports the recorded data in a standardized way. It 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* 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.

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

Illustration 1.1 summarizes the activities of the accounting process.

ILLUSTRATION 1.1 **The activities of the accounting process**



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

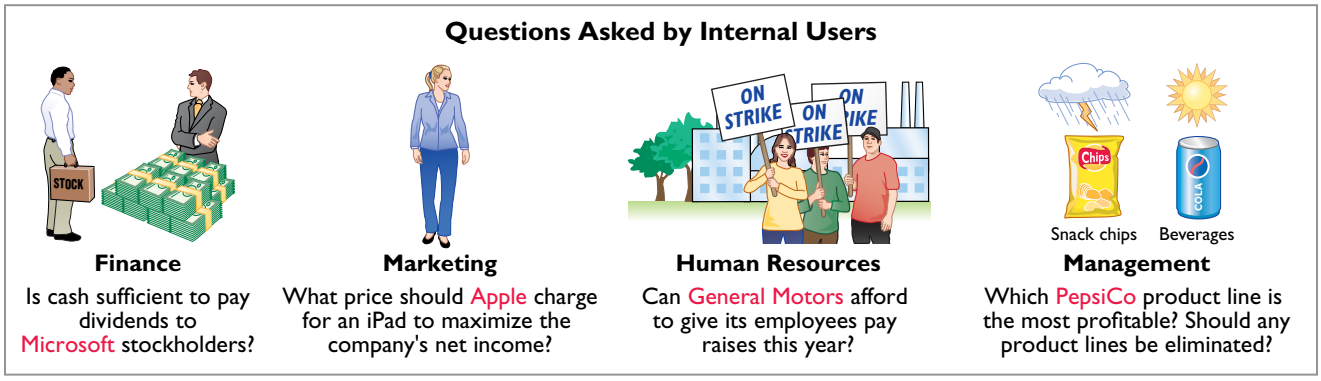
Who Uses Accounting Data

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.

ILLUSTRATION 1.2 **Questions that internal users ask**



[2]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.

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

© Dan Moore/iStockphoto

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.

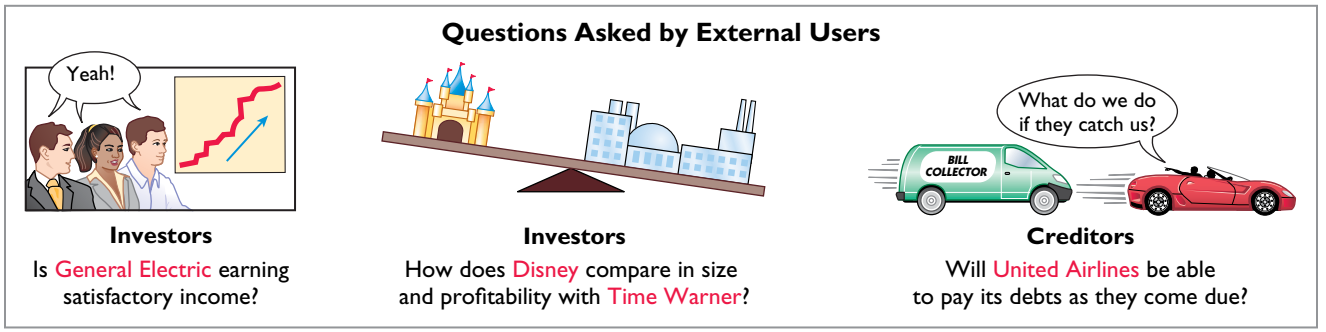
What are the benefits to the company and to the employees of making the financial statements available to all employees? (Go to WileyPLUS for this answer and additional questions.)

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** shows some questions that investors and creditors may ask.

ILLUSTRATION 1.3 **Questions that external users ask**



Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably. **Taxing authorities**, such as the Internal Revenue Service, want to know whether the company complies with tax laws. **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, E1.1, and E1.2.**

The Building Blocks of Accounting

LEARNING OBJECTIVE 2

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

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

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't play the stock market if they think 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**). 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.

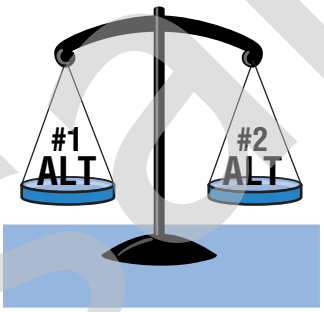
***Ethics Notes** help sensitize you to some of the ethical issues in accounting.*

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**.

ILLUSTRATION 1.4 **Steps in analyzing ethics cases and situations**



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

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

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

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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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.)

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.*

Generally Accepted Accounting Principles

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

The primary accounting standard-setting body in the United States is the **Financial Accounting Standards Board (FASB)**. The **Securities and Exchange Commission (SEC)** is the agency of the U.S. government that oversees U.S. financial markets and accounting standard-setting bodies. The SEC relies on the FASB to develop accounting standards, which public companies must follow. Many countries outside of the United States have adopted the accounting standards issued by the **International Accounting Standards Board (IASB)**. These standards are called **International Financial Reporting Standards (IFRS)** (see **International Note**).

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. In order to increase comparability, 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

Toru-Hanai-Pool/Getty Images, Inc.

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, Japan, and Hong Kong, 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

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.*

GAAP generally uses one of two measurement principles, the historical cost principle or the fair value principle. Selection of which principle to follow generally relates to trade-offs between relevance and faithful representation (see **Helpful Hint**). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

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**). 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, **ExxonMobil**, **Ford**, **Wal-Mart Stores, Inc.**, **Citigroup**, and **Apple**—are corporations.

Accounting Across the Organization

Josef Volavka/iStockphoto

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, E1.3, and E1.4.**

The Accounting Equation

LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes. **Assets** are the resources a business owns. For example, **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**.

Assets	=	Liabilities	+	Owner's Equity

ILLUSTRATION 1.5
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

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).

The ownership claim on total assets is **owner's equity** (see **Helpful Hint**). It is equal to total assets minus total liabilities. Here is why: The assets of a business are claimed by either creditors or owners. To find out what belongs to owners, we subtract the creditors' claims (the liabilities) from assets. The remainder is the owner's claim on the assets—the owner's equity. Since the claims of creditors must be paid **before** ownership claims, owner's equity is often referred to as **residual equity**.

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

ILLUSTRATION 1.6 Expanded accounting equation

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

DO IT! 3 | Owner's Equity Effects

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

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

Solution

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

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

ACTION PLAN

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

Analyzing Business Transactions

LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.

*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 2–4.

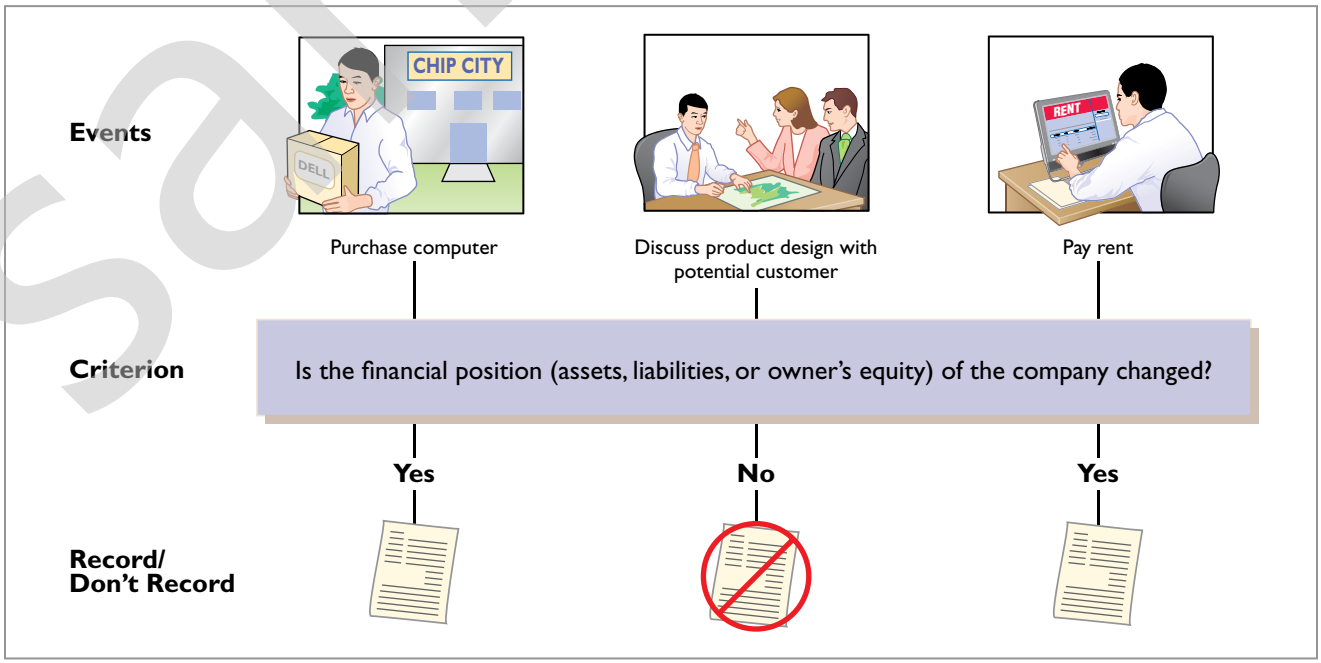
In this textbook, in order to emphasize the underlying concepts and principles, we focus on a manual accounting system. The accounting concepts and principles do not change whether a system is computerized or manual.

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** demonstrates the transaction identification process.

ILLUSTRATION 1.7 **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.

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 Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte, a smartphone app development company (see **Helpful Hint**). Softbyte is the creation of Ray Neal, an entrepreneur who wants to create focused apps

that inspire and engage users of all ages. Ray was encouraged to start his own business after the success of "FoodAlert," a customizable app he developed that tracks the daily location of local food trucks. The following business transactions occur during Softbyte's first month of operations.

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.

Basic Analysis	The asset Cash increases $15,000, and owner's equity (specifically Owner's Capital) increases $15,000.

Equation Analysis

	Assets	=	Liabilities	+	Owner's Equity	
	Cash	=			Owner's Capital	
(1)	**+$15,000**	**=**			**+$15,000**	**Initial investment**

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.

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

Equation Analysis

	Assets			=	Liabilities	+	Owner's Equity
	Cash	+	Equipment	=			Owner's Capital
	$15,000						$15,000
(2)	**−7,000**		**+$7,000**				
	$ 8,000	+	$7,000	=			$15,000
	$15,000						

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

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

Basic Analysis

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

Equation Analysis

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

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

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

Basic Analysis

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

Equation Analysis

	Assets					=	Liabilities	+	Owner's Equity			
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital	+	Revenues	
	$8,000		$1,600		$7,000		$1,600		$15,000			
(4)	+1,200										+$1,200	Service Revenue
	$9,200	+	$1,600	+	$7,000	=	$1,600	+	$15,000	+	$1,200	
			$17,800						$17,800			

The two sides of the equation balance at $17,800. 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.

Basic Analysis

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

Equation Analysis

	Assets					=	Liabilities	+	Owner's Equity					
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Owner's Capital	+	Revenues	–	Expenses	
	$9,200		$1,600		$7,000		$1,600		$15,000		$1,200			
(5)							+250						–$250	Advertising Expense
	$9,200	+	$1,600	+	$7,000	=	$1,850	+	$15,000	+	$1,200	–	$ 250	
			$17,800						$17,800					

The two sides of the equation still balance at $17,800. Owner's equity decreases when Softbyte incurs the expense. Expenses 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.

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

Equation Analysis

	Assets				= Liabilities	+ Owner's Equity			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Owner's Capital	+ Revenues	− Expenses	
	$9,200		$1,600	$7,000	$1,850	$15,000	$1,200	$250	
(6)	+1,500	+$2,000					+3,500		Service Revenue
	$10,700	+ $ 2,000	+ $1,600	+ $7,000	= $1,850	+ $15,000	+ $4,700	− $250	
	$21,300				$21,300				

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.

Basic Analysis	The asset Cash decreases $1,700, and owner's equity decreases $1,700 due to the specific expense categories (Rent Expense, Salaries and Wages Expense, and Utilities Expense).

Equation Analysis

	Assets				= Liabilities	+ Owner's Equity			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Owner's Capital	+ Revenues	− Expenses	
	$10,700	$2,000	$1,600	$7,000	$1,850	$15,000	$4,700	$ 250	
(7)	−1,700							−600	Rent Expense
								−900	Sal. and Wages Exp.
								−200	Utilities Exp.
	$9,000 +	$2,000	+ $1,600	+ $7,000	= $1,850	+ $15,000	+ $4,700	− $1,950	
	$19,600				$19,600				

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.

Basic Analysis

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

Equation Analysis

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

Observe that the payment of a liability related to an expense that has previously been recorded does not affect owner's equity. 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.

Basic Analysis

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

Equation Analysis

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

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

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

Basic Analysis

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

Equation Analysis

	Assets				= Liabilities +	Owner's Equity				
	Cash +	Accounts Receivable +	Supplies +	Equipment	= Accounts Payable +	Owner's Capital −	Owner's Drawings +	Revenues −	Expenses	
	$9,350	$1,400	$1,600	$7,000	$1,600	$15,000		$4,700	$1,950	
(10)	−1,300						−$1,300			Drawings
	$8,050 +	$1,400 +	$1,600 +	$7,000	= $1,600 +	$15,000 −	$1,300 +	$4,700 −	$1,950	
	$18,050				$18,050					

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

Summary of Transactions

Illustration 1.8 summarizes the September transactions of Softbyte to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction.

Illustration 1.8 demonstrates some significant facts:

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

ILLUSTRATION 1.8 **Tabular summary of Softbyte transactions**

	Assets				= Liabilities +	Owner's Equity					
Trans-action	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Owner's Capital	– Owner's Drawings	+ Rev.	– Exp.		
(1)	+$15,000					+ $15,000					Initial invest.
(2)	–7,000			+$7,000							
(3)			+$1,600		+$1,600						
(4)	+1,200							+$1,200			Service Revenue
(5)					+250				–$250		Adver. Expense
(6)	+1,500	+$2,000						+3,500			Service Revenue
(7)	–600								–600		Rent Expense
	–900								–900		Sal./Wages Exp.
	–200								–200		Utilities Expense
(8)	–250				–250						
(9)	+600	–600									
(10)	–1,300						–$1,300				Drawings
	$ 8,050	+ $1,400	+ $1,600	+ $7,000	= $1,600	+ $15,000	– $1,300	+ $4,700	– $1,950		
	$18,050				$18,050						

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.

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

	Assets			=	Liabilities	+	Owner's Equity							
Trans-action	Cash	+	Equipment	=	Accounts Payable	+	Owner's Capital	–	Owner's Drawings	+	Revenues	–	Expenses	
(1)	+$25,000						+$25,000							
(2)			+$7,000		+$7,000									
(3)	+8,000										+$8,000			Service Revenue
(4)	–850												–$850	Rent Expense
(5)	–1,000								–$1,000					Drawings
	$31,150	+	$7,000	=	$7,000	+	$25,000	–	$1,000	+	$8,000	–	$850	
	$38,150								$38,150					

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

The Four Financial Statements

LEARNING OBJECTIVE 5

Describe the four financial statements and how they are prepared.

HELPFUL HINT

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

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

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

These statements provide relevant financial data for internal and external users. **Illustration 1.9** shows the financial statements of Softbyte.

Note that the statements shown in Illustration 1.9 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**.

ALTERNATIVE TERMINOLOGY

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

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. We describe the essential features of each in the following sections.

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

Income Statement

The income statement reports the revenues and expenses for a specific period of time (see **Alternative Terminology**). (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.

ILLUSTRATION 1.9

Financial statements and their interrelationships

Softbyte
Income Statement
For the Month Ended September 30, 2020

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

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

1

Softbyte
Owner's Equity Statement
For the Month Ended September 30, 2020

Owner's capital, September 1		$ –0–
Add: Investments	$15,000	
Net income	**2,750**	17,750
		17,750
Less: Drawings		1,300
Owner's capital, September 30		**$ 16,450**

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

Softbyte
Balance Sheet
September 30, 2020

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

2

3

Softbyte
Statement of Cash Flows
For the Month Ended September 30, 2020

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

The arrows show the interrelationships of the four financial statements.

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

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) 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** shows the presentation of a net loss in the owner's equity statement.

ILLUSTRATION 1.10
Presentation of net loss

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

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) 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**.

ILLUSTRATION 1.11
Presentation of liabilities

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

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

Statement of Cash Flows

The primary purpose of a statement of cash flows is to provide financial information about the cash receipts and cash payments of a company for a specific period of time (see **Helpful Hint**). To help investors, creditors, and others in their analysis of a company's cash position, the statement of cash flows reports the cash effects of a company's operating, investing, and financing activities. 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.

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

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.

People, Planet, and Profit Insight

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Beyond Financial Statements

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

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But many interesting and useful efforts are underway. Throughout this 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, BE1.11, DO IT! 1.5, E1.9, E1.10, E1.11, E1.12, E1.13, E1.14, E1.15, E1.16 , E1.17, and E1.18**

Appendix 1A Career Opportunities in Accounting

LEARNING OBJECTIVE *6

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice? 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**. Keep in mind if you also have a CPA license, you'll make 10–15% more when you start out.

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

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.2 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.

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

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

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:

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

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

The expanded accounting equation is:

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

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

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

Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be

a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in owner's equity.

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

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

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

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

Glossary Review

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

Accounting information system The system of collecting and processing transaction data and communicating financial information to decision-makers. (p. 1-13)

Assets Resources a business owns. (p. 1-11).

***Auditing** The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation. (p. 1-25).

Balance sheet A financial statement that reports the assets, liabilities, and owner's equity at a specific date. (p. 1-20).

Basic accounting equation Assets = Liabilities + Owner's equity. (p. 1-11).

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

Convergence The process of reducing the differences between U.S. GAAP and IFRS. (p. 1-8).

Corporation A business organized as a separate legal entity under state corporation law, having ownership divided into transferable shares of stock. (p. 1-10).

Drawings Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s). (p. 1-12).

Economic entity assumption An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. (p. 1-9).

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

Expanded accounting equation Assets = Liabilities + Owner's capital – Owner's drawings + Revenues – Expenses. (p. 1-12).

Expenses The cost of assets consumed or services used in the process of generating revenue. (p. 1-12).

Fair value principle An accounting principle stating that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). (p. 1-9).

Faithful representation Numbers and descriptions match what really existed or happened—they are factual. (p. 1-8).

Financial accounting The field of accounting that provides economic and financial information for investors, creditors, and other external users. (p. 1-5).

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

***Forensic accounting** An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. (p. 1-25).

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

Historical cost principle An accounting principle that states that companies should record assets at their cost. (p. 1-8).

Income statement A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. (p. 1-20).

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

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

Investments by owner The assets an owner puts into the business. (p. 1-12).

Liabilities Creditor claims against total assets. (p. 1-11).

***Management consulting** An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities. (p. 1-25).

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

Monetary unit assumption An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money. (p. 1-9).

Net income The amount by which revenues exceed expenses. (p. 1-22).

Net loss The amount by which expenses exceed revenues. (p. 1-22).

Owner's equity The ownership claim on total assets. (p. 1-12).

Owner's equity statement A financial statement that summarizes the changes in owner's equity for a specific period of time. (p. 1-20).

Partnership A business owned by two or more persons associated as partners. (p. 1-9).

Proprietorship A business owned by one person. (p. 1-9).

***Public accounting** An area of accounting in which the accountant offers expert service to the general public. (p. 1-24).

Relevance Financial information that is capable of making a difference in a decision. (p. 1-8).

Revenues The increases in assets or decreases in liabilities resulting from the sale of goods or the performance of services in the normal course of business. (p. 1-12).

Sarbanes-Oxley Act (SOX) Law passed by Congress intended to reduce unethical corporate behavior. (p. 1-6).

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

Statement of cash flows A financial statement that summarizes information about the cash inflows (receipts) and cash outflows (payments) for a specific period of time. (p. 1-20).

***Taxation** An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies. (p. 1-25).

Transactions The economic events of a business that are recorded by accountants. (p. 1-14).

Practice Multiple-Choice Questions

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

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

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

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

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

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

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

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

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

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

6. (LO 3) Net income will result during a time period when:

a. assets exceed liabilities.
b. assets exceed revenues.
c. expenses exceed revenues.
d. revenues exceed expenses.

7. (LO 3) 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?

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

8. (LO 4) Performing services on account will have the following effects on the components of the basic accounting equation:

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

9. (LO 4) Which of the following events is **not** recorded in the accounting records?

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

10. (LO 4) During 2020, Bruske Company's assets decreased $50,000 and its liabilities decreased $50,000. Its owner's equity therefore:

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

11. (LO 4) Payment of an account payable affects the components of the accounting equation in the following way.

a. Decreases owner's equity and decreases liabilities.
b. Increases assets and decreases liabilities.
c. Decreases assets and increases owner's equity.
d. Decreases assets and decreases liabilities.

12. (LO 5) Which of the following statements is **false**?

a. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
b. A balance sheet reports the assets, liabilities, and owner's equity at a specific date.
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.
d. An owner's equity statement summarizes the changes in owner's equity for a specific period of time.

13. (LO 5) On the last day of the period, Alan Cesska Company buys a $900 machine on credit. This transaction will affect the:

a. income statement only.

b. balance sheet only.

c. income statement and owner's equity statement only.

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

14. **(LO 5)** The financial statement that reports assets, liabilities, and owner's equity is the:

a. income statement.

b. owner's equity statement.

c. balance sheet.

d. statement of cash flows.

***15.** **(LO 6)** Services performed by a public accountant include:

a. auditing, taxation, and management consulting.

b. auditing, budgeting, and management consulting.

c. auditing, budgeting, and cost accounting.

d. auditing, budgeting, and management consulting.

Solutions

1. b. Economic entity is not one of the steps in the accounting process. The other choices are true because (a) identification is the first step in the accounting process, (c) recording is the second step in the accounting process, and (d) communication is the third and final step in the accounting process.

2. d. Regulatory authorities are external, not internal, users of accounting information. The other choices are true statements.

3. c. The historical cost principle states that assets should be recorded at their cost. The other choices are incorrect because (a) the historical cost principle does not say that assets should be adjusted for changes in fair value, (b) describes the economic entity assumption, and (d) describes the monetary unit assumption.

4. b. The economic entity assumption states that there should be a particular unit of accountability. The other choices are incorrect because (a) basic assumptions are not the same as accounting principles, (c) the monetary unit assumption allows accounting to measure economic events, and (d) partnerships are economic entities.

5. b. Proprietorships, partnerships, and corporations are the three types of business entities. Choices (a) and (c) are incorrect because small and large businesses only denote the sizes of businesses. Choice (d) is incorrect because financial, manufacturing, and service companies are types of businesses, not business entities.

6. d. Net income results when revenues exceed expenses. The other choices are incorrect because (a) assets and liabilities are not used in the computation of net income; (b) revenues, not assets, are included in the computation of net income; and (c) when expenses exceed revenues, a net loss results.

7. a. Using a variation of the basic accounting equation, Assets − Owner's equity = Liabilities, $3,500 − $2,000 = $1,500. Therefore, choices (b) $1,000, (c) $2,500, and (d) $2,000 are incorrect.

8. b. When services are performed on account, assets are increased and owner's equity is increased. The other choices are incorrect because when services are performed on account (a) owner's equity is increased, not decreased; (c) liabilities are not affected; and (d) owner's equity is increased and liabilities are not affected.

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

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

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

12. c. An income statement represents the revenues, expenses, and the resulting net income or net loss for a specific period of time but not the changes in owner's equity. The other choices are true statements.

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

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

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

Practice Brief Exercises

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

Use basic accounting equation.

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

1. **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

Determine effect of transactions on basic accounting equation

2. **(LO 4)** 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.

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

Solution

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

Determine effect of transactions on basic accounting equation.

3. **(LO 4)** Follow the same format as in **Practice Brief Exercise 2.** Determine the effect on assets, liabilities, and owner's equity of the following three transactions.

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
3. **a.**	+	NE	+
b.	+	+	NE
c.	−	NE	−

Determine where items appear on financial statements.

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

a. Owner's capital.
b. Cash.
c. Salaries and wages expense.
d. Service revenue.
e. Accounts payable.

Solution

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

5. (LO 5) **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.

Prepare a balance sheet.

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

Solution

5.

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, 4) 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.
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.

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

2. (LO 3, 4) Alma's Payroll Services Company entered into the following transactions during May 2020.

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

Instructions

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

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

Solution

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

Practice Problem

Prepare a tabular presentation and financial statements.

(LO 4, 5) Joan Robinson opens her own law office on July 1, 2020. During the first month of operations, the following transactions occurred.

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

Instructions

a. Prepare a tabular summary of the transactions.
b. **Financial Statement** Prepare the income statement, owner's equity statement, and balance sheet at July 31, 2020, for Joan Robinson, Attorney.

Solution

a.

	Assets					=	Liabilities			+	Owner's Equity						
Trans-action	Cash	+	Accounts Receivable	+	Equipment	=	Notes Payable	+	Accounts Payable	+	Owner's Capital	−	Owner's Drawings	+	Revenues	−	Expenses
1.	+$11,000					=					+$11,000						
2.	−800																−$800
3.					+$3,000	=			+$3,000								
4.	+1,500														+$1,500		
5.	+700						+$700										
6.			+$2,000												+2,000		
7.	−500																−500
	−300																−300
	−100																−100
8.	−1,000												−$1,000				
	$10,500	+	$2,000	+	$3,000	=	$700	+	$3,000	+	$11,000	−	$1,000	+	$3,500	−	$1,700
	$15,500						$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?

a. Cash.

b. Accounts payable.

c. Owner's drawings.

d. Accounts receivable.

e. Supplies.

f. Equipment.

g. Salaries and wages payable.

h. Service revenue.

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) 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) 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 Berber 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) 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) 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) 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) 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) 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) Follow the same format as in BE1.7. Determine the effect on assets, liabilities, and owner's equity of the following three transactions. *Determine effect of transactions on basic accounting equation.*

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.

Determine effect of transactions on basic owner's equity.

BE1.9 (LO 4) 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).

_____ **a.** Received cash for services performed

_____ **b.** Paid cash to purchase equipment

_____ **c.** Paid employee salaries

Prepare a balance sheet.

BE1.10 (LO 5) **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.

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

Determine where items appear on financial statements.

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

_____ **a.** Notes payable

_____ **b.** Advertising expense

_____ **c.** Owner's capital

_____ **d.** Cash

_____ **e.** Service revenue

DO IT! Exercises

Review basic concepts.

DO IT! 1.1 (LO 1) Indicate whether each of the five statements presented below is true or false.

1. The three steps in the accounting process are identification, recording, and 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.

Identify building blocks of accounting.

DO IT! 1.2 (LO 2) Indicate whether each of the five statements presented below is true or false.

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.

Evaluate effects of transactions on owner's equity.

DO IT! 1.3 (LO 3) 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. Drawings.

2. Rent revenue.

3. Advertising expense.

4. Owner puts personal assets into the business.

Prepare tabular analysis.

DO IT! 1.4 (LO 4) 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.

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

Identify users of accounting information.

_____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**.

Discuss ethics and the historical cost principle.

E1.3 (LO 2) 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."

Instructions

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

Use accounting concepts.

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

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

Instructions

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

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

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

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

Instructions

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

Analyze the effect of transactions.

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

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

Instructions

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

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

E1.7 (LO 4) Falske Computer Timeshare Company entered into the following transactions during May 2020.

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) **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 (LO 5) **Financial Statement** An analysis of transactions for Peat DeLoitte & Co. was presented in E1.8. *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) 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.

Analyze financial statements items.

E1.11 (LO 5) 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.

	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.

Prepare income statement and owner's equity statement.

E1.12 (LO 5) **Financial Statement** The following information relates to Fleete Co. for the year 2020.

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

Instructions

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

Correct an incorrectly prepared balance sheet.

E1.13 (LO 5) **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.

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.

Compute net income and prepare a balance sheet.

E1.14 (LO 5) **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.

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

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) 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) 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) 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) 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

Analyze transactions and compute net income.

Excel

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

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

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

a. Total assets $20,800

b. Net income $6,200

Instructions

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

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

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

Excel

P1.2A (LO 4, 5) **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.

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. Total assets $16,500

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

b. Net income $3,130
Ending capital $11,230

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

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

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

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

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

Instructions

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

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.

a. Net income $4,050
Owner's equity $14,750
Total assets $24,950
b. Owner's equity $15,500

P1.4A (LO 4, 5) **Financial Statement** 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.

a. Total assets $22,000

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

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

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

b. Net income $6,600
c. Cash $14,600

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

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

	Alpha Company	Beta Company	Psi Company	Omega Company
January 1, 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. 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

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

Instructions

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. Financial statements of **Wal-Mart Stores, Inc.** are presented in Appendix E. 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?
   - **a.** Mergers and acquisition activity.
   - **b.** Financial markets.
   - **c.** Multinational corporations.
   - **d.** GAAP is widely considered to be a superior reporting system.
2. The Sarbanes-Oxley Act determines:
   - **a.** international tax regulations.
   - **b.** internal control standards as enforced by the IASB.
   - **c.** internal control standards of U.S. publicly traded companies.
   - **d.** U.S. tax regulations.
3. IFRS is considered to be more:
   - **a.** principles-based and less rules-based than GAAP.
   - **b.** rules-based and less principles-based than GAAP.
   - **c.** detailed than GAAP.
   - **d.** None of the 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. 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

CHAPTER 2

© Nick Laham/Getty Images, Inc.

The Recording Process

Chapter Preview

In Chapter 1, we analyzed business transactions in terms of the accounting equation, and we presented the cumulative effects of these transactions in tabular form. Imagine a company like **MF Global** (as in the following Feature Story) using the same tabular format as Softbyte to keep track of its transactions. In a single day, MF Global engaged in thousands of business transactions. To record each transaction this way would be impractical, expensive, and unnecessary. Instead, companies use a set of procedures and records to keep track of transaction data more easily. This chapter introduces and illustrates these basic procedures and records.

Feature Story

Accidents Happen

How organized are you financially? Take a short quiz. Answer yes or no to each question:

- Does your wallet contain so many cash machine receipts that you've been declared a walking fire hazard?
- Do you wait until your debit card is denied before checking the status of your funds?
- Was Aaron Rodgers (the quarterback for the **Green Bay Packers**) playing high school football the last time you verified the accuracy of your bank account?

If you think it is hard to keep track of the many transactions that make up your life, imagine how difficult it is for a big corporation to do so. Not only that, but now consider how important it is for a large company to have good accounting records, especially if it has control of your life savings. **MF Global Holdings Ltd** was such a company. As a large investment broker, it held billions of dollars of investments for clients. If

you had your life savings invested at MF Global, you might be slightly displeased if you heard this from one of its representatives: "You know, I kind of remember an account for someone with a name like yours—now what did we do with that?"

Unfortunately, that is almost exactly what happened to MF Global's clients shortly before it filed for bankruptcy. During the days immediately following the bankruptcy filing, regulators and auditors struggled to piece things together. In the words of one regulator, "Their books are a disaster . . . we're trying to figure out what numbers are real numbers." One company that considered buying an interest in MF Global walked away from the deal because it "couldn't get a sense of what was on the balance sheet." That company said the information that should have been instantly available instead took days to produce.

It now appears that MF Global did not properly segregate customer accounts from company accounts. And, because of its sloppy recordkeeping, customers were not protected when the company had financial troubles. Total customer losses were approximately $1 billion. As you can see, accounting matters!

Source: S. Patterson and A. Lucchetti, "Inside the Hunt for MF Global Cash," *Wall Street Journal Online* (November 11, 2011).

Chapter Outline

LEARNING OBJECTIVES

LO 1 Describe how accounts, debits, and credits are used to record business transactions.	• The account • Debits and credits • Summary of debit/credit rules	**DO IT! 1** Normal Account Balances
LO 2 Indicate how a journal is used in the recording process.	• The recording process • The journal	**DO IT! 2** Recording Business Activities
LO 3 Explain how a ledger and posting help in the recording process.	• The ledger • Posting • Chart of accounts • The recording process illustrated • Summary illustration of journalizing and posting	**DO IT! 3** Posting
LO 4 Prepare a trial balance.	• Limitations of a trial balance • Locating errors • Dollar signs and underlining	**DO IT! 4** Trial Balance

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Visit WileyPLUS with ORION for additional tutorials and practice opportunities.

Accounts, Debits, and Credits

LEARNING OBJECTIVE 1

Describe how accounts, debits, and credits are used to record business transactions.

The Account

An **account** is an individual accounting record of increases and decreases in a specific asset, liability, or owner's equity item. For example, Softbyte (the company discussed in Chapter 1) would have separate accounts for Cash, Accounts Receivable, Accounts Payable, Service

Revenue, Salaries and Wages Expense, and so on. (Note that whenever we are referring to a specific account, we capitalize the name.)

In its simplest form, an account consists of three parts: (1) a title, (2) a left or debit side, and (3) a right or credit side. Because the format of an account resembles the letter T, we refer to it as a **T-account**. **Illustration 2.1** shows the basic form of an account.

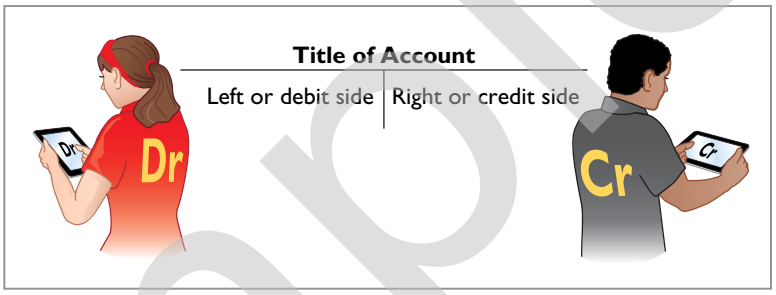


ILLUSTRATION 2.1
Basic form of account

We use this form often throughout this book to explain basic accounting relationships.

Debits and Credits

The term **debit** indicates the left side of an account, and **credit** indicates the right side. They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit. They **do not** mean increase or decrease, as is commonly thought. We use the terms **debit** and **credit** repeatedly in the recording process to describe **where** entries are made in accounts. For example, the act of entering an amount on the left side of an account is called **debiting** the account. Making an entry on the right side is **crediting** the account.

When comparing the totals of the two sides, an account shows a **debit balance** if the total of the debit amounts exceeds the credits. An account shows a **credit balance** if the credit amounts exceed the debits. Note the position of the debit side and credit side in Illustration 2.1.

The procedure of recording debits and credits in an account is shown in **Illustration 2.2** for the transactions affecting the Cash account of Softbyte. The data are taken from the Cash column of the tabular summary in Illustration 1.8.

Tabular Summary

Cash
$15,000
–7,000
1,200
1,500
–1,700
–250
600
–1,300
$ 8,050

Account Form

Cash			
(Debits)	15,000	(Credits)	7,000
	1,200		1,700
	1,500		250
	600		1,300
Balance (Debit)	8,050		

ILLUSTRATION 2.2
Tabular summary and account form for Softbyte's Cash account

Every positive item in the tabular summary represents a receipt of cash. Every negative amount represents a payment of cash. **Notice that in the account form, we record the increases in cash as debits and the decreases in cash as credits.** For example, the $15,000 receipt of cash (in blue) is debited to Cash, and the –$7,000 payment of cash (in red) is credited to Cash.

Having increases on one side and decreases on the other reduces recording errors and helps in determining the totals of each side of the account as well as the account balance. The balance is determined by netting the two sides (subtracting one amount from the other). The account balance, a debit of $8,050, indicates that Softbyte had $8,050 more increases than decreases in cash. In other words, Softbyte started with a balance of zero and now has $8,050 in its Cash account.

Debit and Credit Procedure

INTERNATIONAL NOTE

Rules for accounting for specific events sometimes differ across countries. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.

In Chapter 1, you learned the effect of a transaction on the basic accounting equation. Remember that each transaction must affect two or more accounts to keep the basic accounting equation in balance. In other words, for each transaction, debits must equal credits. The equality of debits and credits provides the basis for the **double-entry system** of recording transactions (see **International Note**).

Under the double-entry system, the dual (two-sided) effect of each transaction is recorded in appropriate accounts. This system provides a logical method for recording transactions and also helps ensure the accuracy of the recorded amounts as well as the detection of errors. If every transaction is recorded with equal debits and credits, the sum of all the debits to the accounts must equal the sum of all the credits.

The double-entry system for determining the equality of the accounting equation is much more efficient than the plus/minus procedure used in Chapter 1. The following discussion illustrates debit and credit procedures in the double-entry system.

Dr./Cr. Procedures for Assets and Liabilities

In Illustration 2.2 for Softbyte, increases in Cash—an asset—are entered on the left side, and decreases in Cash are entered on the right side. We know that both sides of the basic equation (Assets = Liabilities + Owner's Equity) must be equal. It therefore follows that increases and decreases in liabilities have to be recorded **opposite from** increases and decreases in assets. Thus, increases in liabilities are entered on the right or credit side, and decreases in liabilities are entered on the left or debit side. The effects that debits and credits have on assets and liabilities are summarized in **Illustration 2.3**.

ILLUSTRATION 2.3

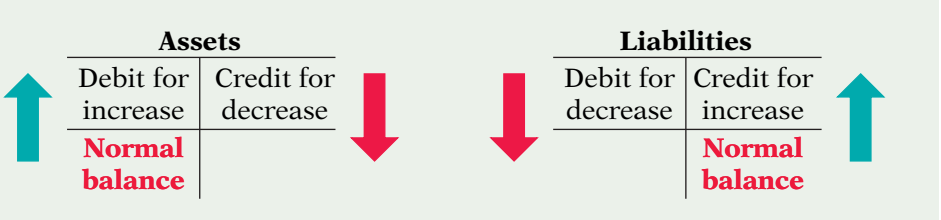
Debit and credit effects—assets and liabilities

Debits	Credits
Increase assets	Decrease assets
Decrease liabilities	Increase liabilities

Asset accounts normally show debit balances. That is, debits to a specific asset account should exceed credits to that account. Likewise, **liability accounts normally show credit balances**. That is, credits to a liability account should exceed debits to that account. The **normal balance** of an account is on the side where an increase in the account is recorded. **Illustration 2.4** shows the normal balances for assets and liabilities.

ILLUSTRATION 2.4

Normal balances—assets and liabilities



Knowing the normal balance in an account may help you trace errors. For example, a credit balance in an asset account such as Land or a debit balance in a liability account such as Salaries and Wages Payable usually indicates an error. Occasionally, though, an abnormal balance may be correct. The Cash account, for example, will have a credit balance when a company has overdrawn its bank balance by spending more than it has in its account.

Dr./Cr. Procedures for Owner's Equity

As Chapter 1 indicated, owner's investments and revenues increase owner's equity. Owner's drawings and expenses decrease owner's equity. Companies keep accounts for each of these types of transactions.

Owner's Capital. Investments by owners are credited to the Owner's Capital account. Credits increase this account, and debits decrease it. When an owner invests cash in the business, the company debits (increases) Cash and credits (increases) Owner's Capital. When the owner's investment in the business is reduced, Owner's Capital is debited (decreased).

Illustration 2.5 shows the rules of debit and credit for the Owner's Capital account.

Debits	Credits
Decrease Owner's Capital	Increase Owner's Capital

ILLUSTRATION 2.5
Debit and credit effects—Owner's Capital

We can diagram the normal balance in Owner's Capital as shown in **Illustration 2.6**.

Owner's Capital

Debit for decrease	Credit for increase
	Normal balance

ILLUSTRATION 2.6
Normal balance—Owner's Capital

Owner's Drawings. An owner may withdraw cash or other assets for personal use. Withdrawals could be debited directly to Owner's Capital to indicate a decrease in owner's equity. However, it is preferable to use a separate account, called Owner's Drawings. This separate account makes it easier to determine total withdrawals for each accounting period. Owner's Drawings is increased by debits and decreased by credits. Normally, the drawings account will have a debit balance.

Illustration 2.7 shows the rules of debit and credit for the Owner's Drawings account.

Debits	Credits
Increase Owner's Drawings	Decrease Owner's Drawings

ILLUSTRATION 2.7
Debit and credit effects—Owner's Drawings

We can diagram the normal balance as shown in **Illustration 2.8**.

Owner's Drawings

Debit for increase	Credit for decrease
Normal balance	

ILLUSTRATION 2.8
Normal balance—Owner's Drawings

The Owner's Drawings account decreases owner's equity. It is not an income statement account like revenues and expenses.

Revenues and Expenses. The purpose of earning revenues is to benefit the owner(s) of the business. When a company recognizes revenues, owner's equity increases. Therefore, **the effect of debits and credits on revenue accounts is the same as their effect on Owner's Capital**. That is, revenue accounts are increased by credits and decreased by debits (see **Helpful Hint**).

Expenses have the opposite effect. Expenses decrease owner's equity. Since expenses decrease net income and revenues increase it, it is logical that the increase and decrease sides of expense accounts should be the opposite of revenue accounts. Thus, expense accounts are increased by debits and decreased by credits. **Illustration 2.9** shows the rules of debits and credits for revenues and expenses.

HELPFUL HINT

Because revenues increase owner's equity, a revenue account has the same debit/credit rules as the Owner's Capital account. Expenses have the opposite effect.

ILLUSTRATION 2.9

Debit and credit effects—revenues and expenses

Debits	Credits
Decrease revenues	Increase revenues
Increase expenses	Decrease expenses

Credits to revenue accounts should exceed debits. Debits to expense accounts should exceed credits. Thus, revenue accounts normally show credit balances, and expense accounts normally show debit balances. **Illustration 2.10** shows the normal balances for revenues and expenses.

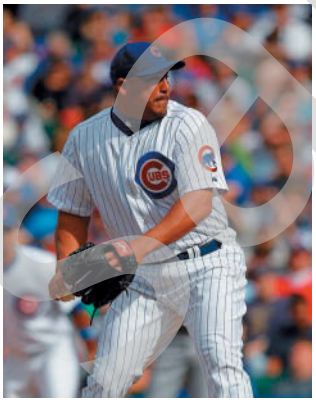
ILLUSTRATION 2.10

Normal balances—revenues and expenses

Revenues	
Debit for decrease	Credit for increase
	Normal balance

Expenses	
Debit for increase	Credit for decrease
Normal balance	

Investor Insight Chicago Cubs



Jonathan Daniel/Getty Images, Inc.

Keeping Score

The **Chicago Cubs** baseball team probably has these major revenue and expense accounts:

Revenues	Expenses
Admissions (ticket sales)	Players' salaries
Concessions	Administrative salaries
Television and radio	Travel
Advertising	Ballpark maintenance

Do you think that the Chicago Bears football team would be likely to have the same major revenue and expense accounts as the Cubs? (Go to WileyPLUS for this answer and additional questions.)

HELPFUL HINT

You may want to bookmark Illustration 2.11. You probably will refer to it often.

Summary of Debit/Credit Rules

Illustration 2.11 shows a summary of the debit/credit rules and effects on each type of account. Study this diagram carefully. It will help you understand the fundamentals of the double-entry system (see **Helpful Hint**).

ILLUSTRATION 2.11 **Summary of debit/credit rules**

Basic Equation

Assets = Liabilities + Owner's Equity

Expanded Equation

Debit / Credit Effects

Assets		=	Liabilities		+	Owner's Capital		–	Owner's Drawings		+	Revenues		–	Expenses	
Dr. +	Cr. –		Dr. –	Cr. +		Dr. –	Cr. +		Dr. +	Cr. –		Dr. –	Cr. +		Dr. +	Cr. –

DO IT! 1 | Normal Account Balances

Kate Browne has just rented space in a shopping mall. In this space, she will open a hair salon to be called "Hair It Is." A friend has advised Kate to set up a double-entry set of accounting records in which to record all of her business transactions.

Identify the balance sheet accounts that Kate will likely need to record the transactions needed to open her business. Indicate whether the normal balance of each account is a debit or a credit.

ACTION PLAN

- **Determine the types of accounts needed. Kate will need asset accounts for each different type of asset she invests in the business and liability accounts for any debts she incurs.**
- **Understand the types of owner's equity accounts. Only Owner's Capital will be needed when Kate begins the business. Other owner's equity accounts will be needed later.**

Solution

Kate would likely need the following accounts in which to record the transactions necessary to ready her hair salon for opening day:

Cash (debit balance)
Equipment (debit balance)
Supplies (debit balance)
Accounts Payable (credit balance)
If she borrows money: Notes Payable (credit balance)
Owner's Capital (credit balance)

Related exercise material: **BE2.1, BE2.2, DO IT! 2.1, E2.1, E2.2, and E2.4.**

The Journal

LEARNING OBJECTIVE 2

Indicate how a journal is used in the recording process.

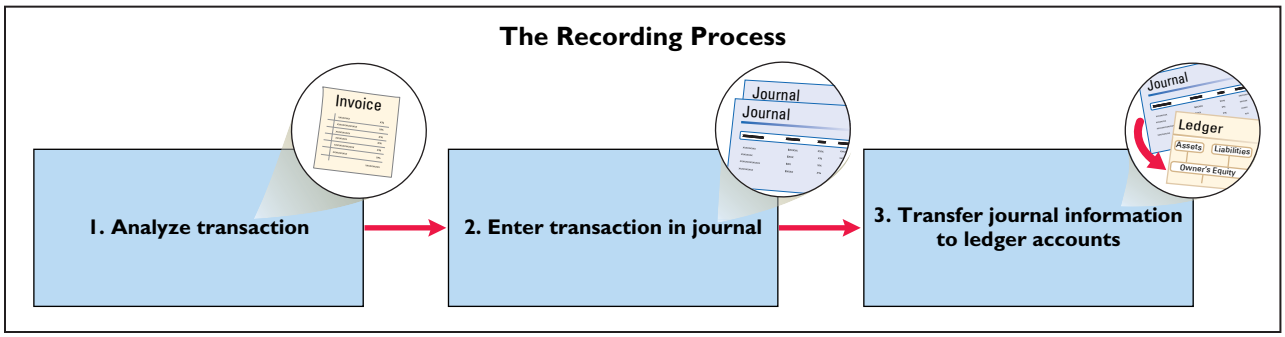
ANALYZE | **Journalize the transactions** | POST | TRIAL BALANCE | ADJUSTING ENTRIES | ADJUSTED TRIAL BALANCE | FINANCIAL STATEMENTS | CLOSING ENTRIES | POST-CLOSING TRIAL BALANCE

The Recording Process

Although it is possible to enter transaction information directly into the accounts, few businesses do so. Practically every business uses the basic steps shown in **Illustration 2.12** in the recording process (an integral part of the accounting cycle):

1. Analyze each transaction in terms of its effect on the accounts.
2. Enter the transaction information in a journal.
3. Transfer the journal information to the appropriate accounts in the ledger.

ILLUSTRATION 2.12 **The recording process**



The steps in the recording process occur repeatedly. In Chapter 1, we illustrated the first step, the analysis of transactions, and will give further examples in this and later chapters. The other two steps in the recording process are explained in the next sections.

The Journal

Companies initially record transactions in chronological order (the order in which they occur). Thus, the **journal** is referred to as the book of original entry. For each transaction, the journal shows the debit and credit effects on specific accounts.

Companies may use various kinds of journals, but every company has the most basic form of journal, a **general journal**. Typically, a general journal has spaces for dates, account titles and explanations, references, and two amount columns. See the format of the journal in Illustration 2.13. *Whenever we use the term "journal" in this textbook, we mean the general journal unless we specify otherwise.*

The journal makes several significant contributions to the recording process:

1. It discloses in one place the **complete effects of a transaction**.
2. It provides a **chronological record** of transactions.
3. It helps to **prevent or locate errors** because the debit and credit amounts for each entry can be easily compared.

Journalizing

Entering transaction data in the journal is known as **journalizing**. Companies make separate journal entries for each transaction. A complete entry consists of (1) the date of the transaction, (2) the accounts and amounts to be debited and credited, and (3) a brief explanation of the transaction.

Illustration 2.13 shows the technique of journalizing, using the first two transactions of Softbyte. Recall that on September 1, Ray Neal invested $15,000 cash in the business, and Softbyte purchased computer equipment for $7,000 cash. The number J1 indicates that these two entries are recorded on the first page of the journal. **Illustration 2.13** shows the standard form of journal entries for these two transactions. (The boxed numbers correspond to explanations in the list below the illustration.)

ILLUSTRATION 2.13
Technique of journalizing

GENERAL JOURNAL				J1
Date	**Account Titles and Explanation**	**Ref.**	**Debit**	**Credit**
2020		5		
Sept. 1	2 Cash		15,000	
1	3 Owner's Capital			15,000
	4 (Owner's investment of cash in business)			
1	Equipment		7,000	
	Cash			7,000
	(Purchase of equipment for cash)			

1 The date of the transaction is entered in the Date column.

2 The debit account title (that is, the account to be debited) is entered first at the extreme left margin of the column headed "Account Titles and Explanation," and the amount of the debit is recorded in the Debit column.

3 The credit account title (that is, the account to be credited) is indented and entered on the next line in the column headed "Account Titles and Explanation," and the amount of the credit is recorded in the Credit column.

4 A brief explanation of the transaction appears on the line below the credit account title. A space is left between journal entries. The blank space separates individual journal entries and makes the entire journal easier to read.

5 The column titled Ref. (which stands for Reference) is left blank when the journal entry is made. This column is used later when the journal entries are transferred to the individual accounts.

It is important to use correct and specific account titles in journalizing. Erroneous account titles lead to incorrect financial statements. However, some flexibility exists initially in selecting account titles. The main criterion is that each title must appropriately describe the content of the account. Once a company chooses the specific title to use, it should record under that account title all later transactions involving the account. *In homework problems, you should use specific account titles when they are given.* When account titles are not given, you may select account titles that identify the nature and content of each account. The account titles used in journalizing should not contain explanations such as Cash Paid or Cash Received.

Simple and Compound Entries

Some entries involve only two accounts, one debit and one credit. (See, for example, the entries in Illustration 2.13.) This type of entry is called a **simple entry**. Some transactions, however, require more than two accounts in journalizing. An entry that requires three or more accounts is a **compound entry**. To illustrate, assume that on July 1, Butler Company purchases a delivery truck costing $14,000. It pays $8,000 cash now and agrees to pay the remaining $6,000 on account (to be paid later). **Illustration 2.14** shows the compound entry.

ILLUSTRATION 2.14
Compound journal entry

GENERAL JOURNAL				J1
Date	**Account Titles and Explanation**	**Ref.**	**Debit**	**Credit**
2020				
July 1	Equipment		14,000	
	Cash			8,000
	Accounts Payable			6,000
	(Purchased truck for cash with balance on account)			

In a compound entry, the standard format requires that all debits be listed before the credits.

Accounting Across the Organization Hain Celestial Group

Keith Homan/ Shutterstock

It Starts with the Transaction

Recording financial transactions in a company's records should be straightforward. If a company determines that a transaction involves revenue, it records revenue. If it has an expense, then it records an expense. However, sometimes this is difficult to do. For example, for more than a year, **Hain Celestial Group** (an organic food company) did not provide income information to investors and regulators. The reason was that the company discovered revenue irregularities and said it could not release financial results until it determined when and how to record revenue for certain transactions. When Hain missed four deadlines for reporting earnings information, the food company suffered a 34% drop in its stock price. As one analyst noted, it was hard to fathom why a seemingly simple revenue recognition issue took one year to resolve.

In other situations, outright fraud may occur. For example, regulators charged **Obsidian Energy** for fraudulently moving millions of dollars in expenses from operating expenses to capital expenditure accounts. By understating reported operating expenses, Obsidian made it appear that it was efficiently managing its costs as well as increasing its income.

These examples demonstrate that "getting the basic transaction right" is the foundation for relevant and reliable financial statements. Starting with an incorrect or inappropriate transaction leads to distortions in the financial statements.

Sources: Shawn Tully, "The Mystery of Hain Celestial's Accounting," *Fortune.com* (August 20, 2016); and Kelly Cryderman, "U.S. Charges Obsidian, Formerly Penn West, with Accounting Fraud," *The Globe and Mail* (June 28, 2017).

Why is it important for companies to record financial transactions completely and accurately? (Go to WileyPLUS for this answer and additional questions.)

DO IT! 2 | Recording Business Activities

Kate Browne engaged in the following activities in establishing her salon, Hair It Is:

1. Opened a bank account in the name of Hair It Is and deposited $20,000 of her own money in this account as her initial investment.
2. Purchased equipment on account (to be paid in 30 days) for a total cost of $4,800.
3. Interviewed three people for the position of hair stylist.

Prepare the journal entries to record the transactions.

ACTION PLAN

- **Understand which activities need to be recorded and which do not. Any that affect assets, liabilities, or owner's equity should be recorded in a journal.**
- **Analyze the effects of transactions on asset, liability, and owner's equity accounts.**

Solution

The three activities would be recorded as follows.

1. Cash	20,000	
Owner's Capital		20,000
(Owner's investment of cash in business)		
2. Equipment	4,800	
Accounts Payable		4,800
(Purchase of equipment on account)		

3. No entry because no transaction has occurred.

Related exercise material: **BE2.3, BE2.4, BE2.5, BE2.6, DO IT! 2.2, E2.3, E2.5, E2.6, E2.7, E2.8, and E2.9.**

The Ledger and Posting

LEARNING OBJECTIVE 3

Explain how a ledger and posting help in the recording process.

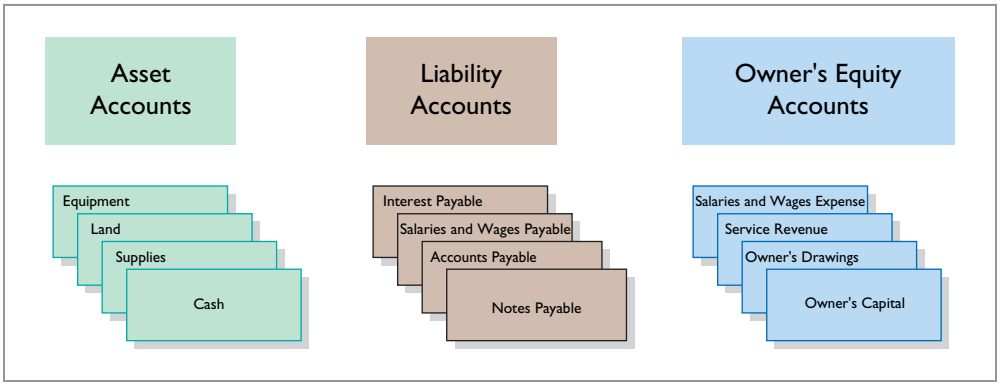
The Ledger

The entire group of accounts maintained by a company is the **ledger**. The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.

Companies may use various kinds of ledgers, but every company has a general ledger. A **general ledger** contains all the asset, liability, and owner's equity accounts, as shown in **Illustration 2.15**. *Whenever we use the term "ledger" in this textbook, we are referring to the general ledger unless we specify otherwise.*

ILLUSTRATION 2.15

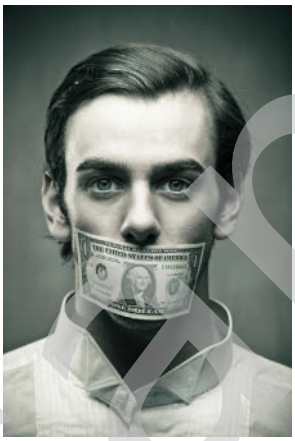
The general ledger, which contains all of a company's accounts



Companies arrange the ledger in the sequence in which they present the accounts in the financial statements, beginning with the balance sheet accounts. First in order are the asset accounts, followed by liability accounts, owner's capital, owner's drawings, revenues, and expenses. Each account is numbered for easier identification.

The ledger provides the balance in each of the accounts. For example, the Cash account shows the amount of cash available to meet current obligations. The Accounts Receivable account shows amounts due from customers. Accounts Payable shows amounts owed to creditors.

Ethics Insight Credit Suisse Group



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A Convenient Overstatement

Sometimes a company's investment securities suffer a permanent decline in value below their original cost. When this occurs, the company is supposed to reduce the recorded value of the securities on its balance sheet ("write them down" in common financial lingo) and record a loss. It appears, however, that during the financial crisis of 2008, employees at some financial institutions chose to look the other way as the value of their investments skidded.

A number of Wall Street traders that worked for the investment bank **Credit Suisse Group** were charged with intentionally overstating the value of securities that had suffered declines of approximately $2.85 billion. One reason that they may have been reluctant to record the losses is out of fear that the company's shareholders and clients would panic if they saw the magnitude of the losses. However, personal self-interest might have been equally to blame—the bonuses of the traders were tied to the value of the investment securities.

Source: S. Pulliam, J. Eaglesham, and M. Siconolfi, "U.S. Plans Changes on Bond Fraud," *Wall Street Journal Online* (February 1, 2012).

What incentives might employees have had to overstate the value of these investment securities on the company's financial statements? (Go to WileyPLUS for this answer and additional questions.)

Standard Form of Account

The simple T-account form used in accounting textbooks is often very useful for illustration purposes. However, in practice, the account forms used in ledgers are much more structured. **Illustration 2.16** shows a typical form, using assumed data from a cash account.

ILLUSTRATION 2.16
Three-column form of account

CASH					NO. 101
Date	**Explanation**	**Ref.**	**Debit**	**Credit**	**Balance**
2020					
June 1			25,000		25,000
2				8,000	17,000
3			4,200		21,200
9			7,500		28,700
17				11,700	17,000
20				250	16,750
30				7,300	9,450

This format is called the **three-column form of account**. It has three money columns—debit, credit, and balance. The balance in the account is determined after each transaction. Companies use the explanation space and reference columns to provide special information about the transaction.

Posting

The procedure of transferring journal entries to the ledger accounts is called **posting**. This phase of the recording process accumulates the effects of journalized transactions into the individual accounts. Posting involves the following steps.

1. In the **ledger**, in the appropriate columns of the account(s) debited, enter the date, journal page, and debit amount shown in the journal.
2. In the reference column of the **journal**, write the account number to which the debit amount was posted.
3. In the **ledger**, in the appropriate columns of the account(s) credited, enter the date, journal page, and credit amount shown in the journal.
4. In the reference column of the **journal**, write the account number to which the credit amount was posted.

Illustration 2.17 shows these four steps using Softbyte's first journal entry. The boxed numbers indicate the sequence of the steps.

ILLUSTRATION 2.17
Posting a journal entry

GENERAL JOURNAL J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2020 Sept.1	Cash	101	15,000	
	Owner's Capital	301		15,000
	(Owner's investment of cash in business)			

GENERAL LEDGER

Cash No.101

Date	Explanation	Ref.	Debit	Credit	Balance
2020 Sept.1		J1	15,000		15,000

Owner's Capital No.301

Date	Explanation	Ref.	Debit	Credit	Balance
2020 Sept.1		J1		15,000	15,000

Key: 1 Post to debit account–date, journal page number, and amount.
2 Enter debit account number in journal reference column.
3 Post to credit account–date, journal page number, and amount.
4 Enter credit account number in journal reference column.

Posting should be performed in chronological order. That is, the company should post all the debits and credits of one journal entry before proceeding to the next journal entry. Postings should be made on a timely basis to ensure that the ledger is up-to-date. *In homework problems, you can journalize all transactions before posting any of the journal entries.*

The reference column of a ledger account indicates the journal page from which the transaction was posted. (After the last entry has been posted, the accountant should scan the reference column **in the journal**, to confirm that all postings have been made.) The explanation space of the ledger account is used infrequently because an explanation already appears in the journal.

Chart of Accounts

The number and type of accounts differ for each company. The number of accounts depends on the amount of detail management desires. For example, the management of one company may want a single account for all types of utility expense. Another may keep separate expense accounts for each type of utility, such as gas, electricity, and water. Similarly, a small company like Softbyte will have fewer accounts than a corporate giant like **Dell**. Softbyte may be able to manage and report its activities in 20 to 30 accounts, while Dell may require thousands of accounts to keep track of its worldwide activities.

Most companies have a **chart of accounts**. This chart lists the accounts and the account numbers that identify their location in the ledger. The numbering system that identifies the accounts usually starts with the balance sheet accounts and follows with the income statement accounts.

In this and the next two chapters, we explain the accounting for Pioneer Advertising (a service company). Accounts 101–199 indicate asset accounts; 200–299 indicate liabilities; 301–350 indicate owner's equity accounts; 400–499, revenues; 601–799, expenses; 800–899, other revenues; and 900–999, other expenses. **Illustration 2.18** shows Pioneer's chart of accounts. Accounts listed in red are used in this chapter; accounts shown in black are explained in later chapters.

ILLUSTRATION 2.18
Chart of accounts

Pioneer Advertising
Chart of Accounts

Assets	Owner's Equity
101 Cash	301 Owner's Capital
112 Accounts Receivable	306 Owner's Drawings
126 Supplies	350 Income Summary
130 Prepaid Insurance	
157 Equipment	**Revenues**
158 Accumulated Depreciation—Equipment	400 Service Revenue
Liabilities	**Expenses**
200 Notes Payable	631 Supplies Expense
201 Accounts Payable	711 Depreciation Expense
209 Unearned Service Revenue	722 Insurance Expense
212 Salaries and Wages Payable	726 Salaries and Wages Expense
230 Interest Payable	729 Rent Expense
	732 Utilities Expense
	905 Interest Expense

You will notice that there are gaps in the numbering system of the chart of accounts for Pioneer. Companies leave gaps to permit the insertion of new accounts as needed during the life of the business.

The Recording Process Illustrated

Illustrations 2.19 through **2.28** show the basic steps in the recording process, using the October transactions of Pioneer Advertising (see **Helpful Hint**). Pioneer's accounting period is a month. In these illustrations, a basic analysis, an equation analysis, and a debit-credit analysis precede the journal entry and posting of each transaction. For simplicity, we use the T-account form to show the posting instead of the standard account form.

HELPFUL HINT
The Accounting Cycle Tutorial in WileyPLUS provides an interactive presentation of the accounting cycle using these transaction analyses.

Study these transaction analyses carefully. **The purpose of transaction analysis is first to identify the type of account involved, and then to determine whether to make a debit**

or a credit to the account. You should always perform this type of analysis before preparing a journal entry. Doing so will help you understand the journal entries discussed in this chapter as well as more complex journal entries in later chapters (see **Helpful Hint**).

ILLUSTRATION 2.19

Investment of cash by owner

Cash flow analyses show the impact of each transaction on cash.

Cash Flows
+10,000

HELPFUL HINT

Follow these steps:
1. **Determine what type of account is involved.**
2. **Determine what items increased or decreased and by how much.**
3. **Translate the increases and decreases into debits and credits.**

Transaction

On October 1, C. R. Byrd invests $10,000 cash in an advertising company called Pioneer Advertising.

Basic Analysis

The asset Cash increases $10,000; owner's equity (specifically, Owner's Capital) increases $10,000.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
				Owner's Capital
Cash	=			
+$10,000				+$10,000

Debit–Credit Analysis

Debits increase assets: debit Cash $10,000.
Credits increase owner's equity: credit Owner's Capital $10,000.

Journal Entry

Oct. 1	Cash	101	10,000	
	Owner's Capital	301		10,000
	(Owner's investment of cash in business)			

Posting

Cash 101			Owner's Capital 301		
Oct. 1	10,000			Oct. 1	10,000

ILLUSTRATION 2.20

Purchase of office equipment

Cash Flows
no effect

Transaction

On October 1, Pioneer purchases office equipment costing $5,000 by signing a 3-month, 12%, $5,000 note payable.

Basic Analysis

The asset Equipment increases $5,000; the liability Notes Payable increases $5,000.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
		Notes Payable		
Equipment	=			
+$5,000		+$5,000		

Debit–Credit Analysis

Debits increase assets: debit Equipment $5,000.
Credits increase liabilities: credit Notes Payable $5,000.

Journal Entry

Oct. 1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			

Posting

Equipment 157			Notes Payable 200		
Oct. 1	5,000			Oct. 1	5,000

ILLUSTRATION 2.21

Receipt of cash for future service

Transaction

On October 2, Pioneer receives a $1,200 cash advance from R. Knox, a client, for advertising services that are expected to be completed by December 31.

Basic Analysis

The asset Cash increases $1,200; the liability Unearned Service Revenue increases $1,200 because the service has not been performed yet. That is, when Pioneer receives an advance payment, it should record an unearned revenue (a liability) in order to recognize the obligation that exists.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
Cash	=	Unearned Service Revenue		
+$1,200		+$1,200		

Debit–Credit Analysis

Debits increase assets: debit Cash $1,200.
Credits increase liabilities: credit Unearned Service Revenue $1,200.

Journal Entry

Oct. 2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future services)			

Posting

Cash 101			
Oct. 1	10,000		
2	1,200		

Unearned Service Revenue 209			
		Oct. 2	1,200

Many liabilities have the word "payable" in their title. But, note that Unearned Service Revenue is considered a liability even though the word *payable* is not used.

Cash Flows
+1,200

ILLUSTRATION 2.22

Payment of monthly rent

Transaction

On October 3, Pioneer pays office rent for October in cash, $900.

Basic Analysis

The expense account Rent Expense increases $900 because the payment pertains only to the current month; the asset Cash decreases $900.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
Cash	=			Rent Expense
-$900				-$900

Debit–Credit Analysis

Debits increase expenses: debit Rent Expense $900.
Credits decrease assets: credit Cash $900.

Journal Entry

Oct. 3	Rent Expense	729	900	
	Cash	101		900
	(Paid cash for October office rent)			

Posting

Cash 101			
Oct. 1	10,000	Oct. 3	900
2	1,200		

Rent Expense 729			
Oct. 3	900		

Cash Flows
−900

ILLUSTRATION 2.23

Payment for insurance

Cash Flows
−600

Transaction

On October 4, Pioneer pays $600 for a one-year insurance policy that will expire next year on September 30.

Basic Analysis

The asset Prepaid Insurance increases $600 because the payment extends to more than the current month; the asset Cash decreases $600. Payments of expenses that will benefit more than one accounting period are prepaid expenses or prepayments. When a company makes a payment, it debits an asset account in order to show the service or benefit that will be received in the future.

Equation Analysis

Assets			=	Liabilities	+	Owner's Equity
Cash	+	Prepaid Insurance				
-$600		+$600				

Debit–Credit Analysis

Debits increase assets: debit Prepaid Insurance $600.
Credits decrease assets: credit Cash $600.

Journal Entry

Oct. 4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			

Posting

Cash 101			
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600

Prepaid Insurance 130			
Oct. 4	600		

ILLUSTRATION 2.24

Purchase of supplies on credit

Cash Flows
no effect

Transaction

On October 5, Pioneer purchases an estimated 3-month supply of advertising materials on account from Aero Supply for $2,500.

Basic Analysis

The asset Supplies increases $2,500; the liability Accounts Payable increases $2,500.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
Supplies	=	Accounts Payable		
+$2,500		+$2,500		

Debit–Credit Analysis

Debits increase assets: debit Supplies $2,500.
Credits increase liabilities: credit Accounts Payable $2,500.

Journal Entry

Oct. 5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			

Posting

Supplies 126			
Oct. 5	2,500		

Accounts Payable 201			
		Oct. 5	2,500

ILLUSTRATION 2.25

Hiring of employees

Event	On October 9, Pioneer hires four employees to begin work on October 15. Each employee is to receive a weekly salary of $500 for a 5-day work week, payable every 2 weeks—first payment made on October 26.
Basic Analysis	A business transaction has not occurred. There is only an agreement between the employer and the employees to enter into a business transaction beginning on October 15. Thus, a debit–credit analysis is not needed because there is no accounting entry (see October 26 transaction for first entry).

Cash Flows
no effect

ILLUSTRATION 2.26

Withdrawal of cash by owner

Transaction	On October 20, C. R. Byrd withdraws $500 cash for personal use.
Basic Analysis	The owner's equity account Owner's Drawings increases $500; the asset Cash decreases $500.
Equation Analysis	**Assets** = **Liabilities** + **Owner's Equity** Cash = Owner's Drawings -$500 = -$500
Debit–Credit Analysis	Debits increase drawings: debit Owner's Drawings $500. Credits decrease assets: credit Cash $500.

Journal Entry

Oct. 20	Owner's Drawings Cash (Withdrew cash for personal use)	306 101	500	500

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500

Owner's Drawings			306
Oct. 20	500		

Cash Flows
–500

ILLUSTRATION 2.27

Payment of salaries

Cash Flows
−4,000

Transaction

On October 26, Pioneer owes employee salaries of $4,000 and pays them in cash (see October 9 event).

Basic Analysis

The expense account Salaries and Wages Expense increases $4,000; the asset Cash decreases $4,000.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
				Salaries and Wages Expense
Cash	=			
-$4,000				-$4,000

Debit–Credit Analysis

Debits increase expenses: debit Salaries and Wages Expense $4,000.
Credits decrease assets: credit Cash $4,000.

Journal Entry

Oct. 26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500
		26	4,000

Salaries and Wages Expense			726
Oct. 26	4,000		

ILLUSTRATION 2.28

Receipt of cash for services performed

Cash Flows
+10,000

Transaction

On October 31, Pioneer receives $10,000 in cash from Copa Company for advertising services performed in October.

Basic Analysis

The asset Cash increases $10,000; the revenue account Service Revenue increases $10,000.

Equation Analysis

Assets	=	Liabilities	+	Owner's Equity
				Service Revenue
Cash	=			
+$10,000				+$10,000

Debit–Credit Analysis

Debits increase assets: debit Cash $10,000.
Credits increase revenues: credit Service Revenue $10,000.

Journal Entry

Oct. 31	Cash	101	10,000	
	Service Revenue	400		10,000
	(Received cash for services performed)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
31	10,000	20	500
		26	4,000

Service Revenue			400
		Oct. 31	10,000

Summary Illustration of Journalizing and Posting

Illustration 2.29 shows the journal for Pioneer Advertising for October.

ILLUSTRATION 2.29
General journal entries

GENERAL JOURNAL				PAGE J1
Date	**Account Titles and Explanation**	**Ref.**	**Debit**	**Credit**
2020				
Oct. 1	Cash	101	10,000	
	Owner's Capital	301		10,000
	(Owner's investment of cash in business)			
1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			
2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future services)			
3	Rent Expense	729	900	
	Cash	101		900
	(Paid cash for October office rent)			
4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			
5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			
20	Owner's Drawings	306	500	
	Cash	101		500
	(Withdrew cash for personal use)			
26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			
31	Cash	101	10,000	
	Service Revenue	400		10,000
	(Received cash for services performed)			

Illustration 2.30 shows the ledger, with all balances in red.

ILLUSTRATION 2.30 **General ledger**

GENERAL LEDGER

Cash **No. 101**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 1		J1	10,000		10,000
2		J1	1,200		11,200
3		J1		900	10,300
4		J1		600	9,700
20		J1		500	9,200
26		J1		4,000	5,200
31		J1	10,000		**15,200**

Supplies **No. 126**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 5		J1	2,500		**2,500**

Prepaid Insurance **No. 130**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 4		J1	600		**600**

Equipment **No. 157**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 1		J1	5,000		**5,000**

Notes Payable **No. 200**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 1		J1		5,000	**5,000**

Accounts Payable **No. 201**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 5		J1		2,500	**2,500**

Unearned Service Revenue **No. 209**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 2		J1		1,200	**1,200**

Owner's Capital **No. 301**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 1		J1		10,000	**10,000**

Owner's Drawings **No. 306**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 20		J1	500		**500**

Service Revenue **No. 400**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 31		J1		10,000	**10,000**

Salaries and Wages Expense **No. 726**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 26		J1	4,000		**4,000**

Rent Expense **No. 729**

Date	Explanation	Ref.	Debit	Credit	Balance
2020					
Oct. 3		J1	900		**900**

DO IT! 3 | Posting

Kate Browne recorded the following transactions in a general journal during the month of March.

Mar. 4	Cash	2,280	
	Service Revenue		2,280
15	Salaries and Wages Expense	400	
	Cash		400
19	Utilities Expense	92	
	Cash		92

Post these entries to the Cash account of the general ledger to determine its ending balance. The beginning balance of Cash on March 1 was $600.

ACTION PLAN

- **Recall that posting involves transferring the journalized debits and credits to specific accounts in the ledger.**
- **Determine the ending balance by netting the total debits and credits.**

Solution

Cash

3/1 Bal.	600	3/15	400
3/4	2,280	3/19	92
3/31 Bal.	2,388		

Related exercise material: **BE2.7, BE2.8, DO IT! 2.3, E2.11, and E2.14.**