fifth edition

FINANCIAL ACCOUNTING

Robert Kemp Jeffrey Waybright

The authors and Pearson Education, Inc. wish to thank Susan and Brian Miller, owners of Bold City Brewery, for their contributions to this edition of *Financial Accounting*. They and their team have helped us make accounting come alive for students by showing the importance of financial accounting in making any business a success.

Dedication

I dedicate this book to my beloved children: Adam, Meg, and Sarah. I also dedicate this book to their spouses and children. They give meaning to my life, and are my dream come true.

Robert Kemp

I dedicate this edition to my wife, Lynne (aka Buttercup). You are such a special gift to me.

Jeffrey Waybright

About the Authors

Robert Kemp, DBA, CPA, is the Ramon W. Breeden, Sr., Research Professor at the McIntire School of Commerce in the University of Virginia. He is a certified public accountant and possesses baccalaureate, master's, and doctorate degrees in business administration.

Professor Kemp is an accomplished scholar who conducts research and writing in the theory and practice of contemporary business. He currently is conducting research in the funding of pensions, the management of financial institutions, and corporate finance. His scholarly works include 70 completed projects, including monographs, articles, cases, research presentations, and working papers. His work is published in, among other places, *The Financial Review; The Journal of Financial Research; Advances in Accounting, A Research Journal; Benefits Quarterly; The Journal of Mathematics Applied in Business and Industry; The Journal of Accountancy; The Journal of Commercial Bank Lending; The Journal of Bank Accounting and Auditing;* and *The Journal of Business Economics.*

Professor Kemp is an accomplished teacher to university students and executives throughout the world. During his 36 years at the University of Virginia, he has taught numerous undergraduate and graduate courses using lectures, case studies, discussion groups, and distance learning. His consistently high evaluations by students reflect his devotion to the classroom. This high quality is also seen in his teaching of business executives. He has worked with and taught for organizations such as Bank of America, the FDIC, Navigant—Tucker Alan, the Siberian Banking Institute, the Barents Group, KPMG, Gerson Lehrman, Wellington Management, the Russian Bankers Association, the Central Asian American Enterprise Fund, the American Institute of Certified Public Accountants, and the Consumer Bankers Association.

Jeffrey Waybright teaches accounting at Spokane Community College, which is part of a multi-college district in eastern Washington. He has been a full-time, tenured, community college instructor for more than 25 years, and has also taught upper division courses for Linfield College. He is a co-recipient of the Washington Society of CPA's Outstanding Educator Award.

Mr. Waybright received his bachelor of arts degree in business administration (with an emphasis in accounting) and master's of arts degree from Eastern Washington University. Before becoming a professor, he spent eight years as a practicing CPA in Washington state, and still holds his license. During his teaching career, he has taught many disciplines of accounting, including financial, managerial, computerized, and payroll accounting, as well as the disciplines of entrepreneurship, economics, business math, and general business. Mr. Waybright developed online courses in accounting, teaches online and traditional courses for financial and managerial accounting, and advises students. He is passionate about teaching students the subject of accounting.

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Preface

Changes to This Edition

Chapter 1 Business, Accounting, and You

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 2 Analyzing and Recording Business Transactions

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 3 Adjusting and Closing Entries

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 4 Accounting for a Merchandising Business

- Fully integrated the new revenue recognition standard in text, exercises and problems.
- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.

- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 5 Inventory

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 6 The Challenges of Accounting: Standards, Internal Control, Audits, Fraud, and Ethics

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the auditor's responsibilities with regard to auditing internal controls.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 7 Cash and Receivables

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 8 Long-Term and Other Assets

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 9 Current Liabilities and Long-Term Debt

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 10 Corporations: Paid-In Capital and Retained Earnings

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 11 The Statement of Cash Flows

- Expanded the use of Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Chapter 12 Financial Statement Analysis

- Expanded the use of the Bold City Brewery, a real-life successful entrepreneurial venture, to demonstrate the use and importance of accounting.
- Updated the "Try It!" problem.
- Updated the examples used in "How They Do It: A Look at Business."
- Updated the Continuing Financial Statement Analysis Problem featuring Dick's Sporting Goods using the 2016 annual report.
- Updated end-of-chapter material related to Columbia Sportswear and Under Armour using the 2016 annual reports.

Solving Teaching and Learning Challenges

Dear Colleagues,

We are very excited about the newest edition of Kemp and Waybright's *Financial Accounting*. After you have had a chance to look at this edition's changes, we think you will be as excited about our latest edition as we are.

Practical Approach: Accounting from a Business Perspective
As has been our goal in past editions, the fifth edition of *Financial Accounting* is all about helping students learn. We believe the text and supporting materials tackle challenging topics in a pragmatic, easily understood manner so that students understand not only accounting but its critical role in the business world. We want to help you help your students master the basic concepts of financial accounting and apply them to everyday business decisions.

To help with this goal, we've focused the fifth edition on businesses to which students can better relate. First, we use Bold City Brewery—a successful, entrepreneurial business—to introduce, develop, and demonstrate the topic of each chapter. We conclude each chapter by showing the importance of the chapter topic to Bold City Brewery and larger firms. Second, throughout the chapter and at the end of the chapter, we use examples and problems that reflect typical businesses that students encounter in their real lives. This means smaller and more manageable numbers.

Execution: Ensuring Student Success
Every feature in *Financial Accounting* is about helping you, the faculty, help your students achieve this goal. Based on our years of teaching, we believe we have created a complete package of instructional materials using traditional and digital methods. For example, examine how each topic is introduced, explained, and demonstrated. Notice how students not only learn the topic, but also see how it is applied in the real world. Moreover, the end-of-chapter exercises, problems, and cases, all prepared by us, create a progressive and appropriately challenging learning experience. Included in this edition are more than 18 live examples so students can test their understanding of the relationship between the general journal, journal entries, and the impact on the accounting equation. These materials were all crafted carefully to help you ensure your students have more of those "I get it" moments.

Assessment: Ensuring Your Success
We are first and foremost teachers. It's our passion. We understand the challenges you face as teachers. For example, to assure continuity between the text and the assessments, we prepared the solutions manual and contributed to the algorithmic test bank, which we also checked for accuracy. In addition to these supplements, there are automatically graded homework assignments in MyLab Accounting.

We believe in this text. Every day, we see how this text and supporting materials help students learn in and out of the classroom. We believe you too will love this text. We believe you will quickly see how *Financial Accounting*, with all of its supporting materials, creates success in your students.

Thank you for looking at *Financial Accounting.* We believe that the fifth edition of *Financial Accounting* is unique. It's special. We hope you'll look at it, compare it to other books, and think about what is best for your students and you. If you do, we think there is one obvious choice: Kemp and Waybright's *Financial Accounting*. It's all about success for you and your students.

Best wishes,

Bob Kemp
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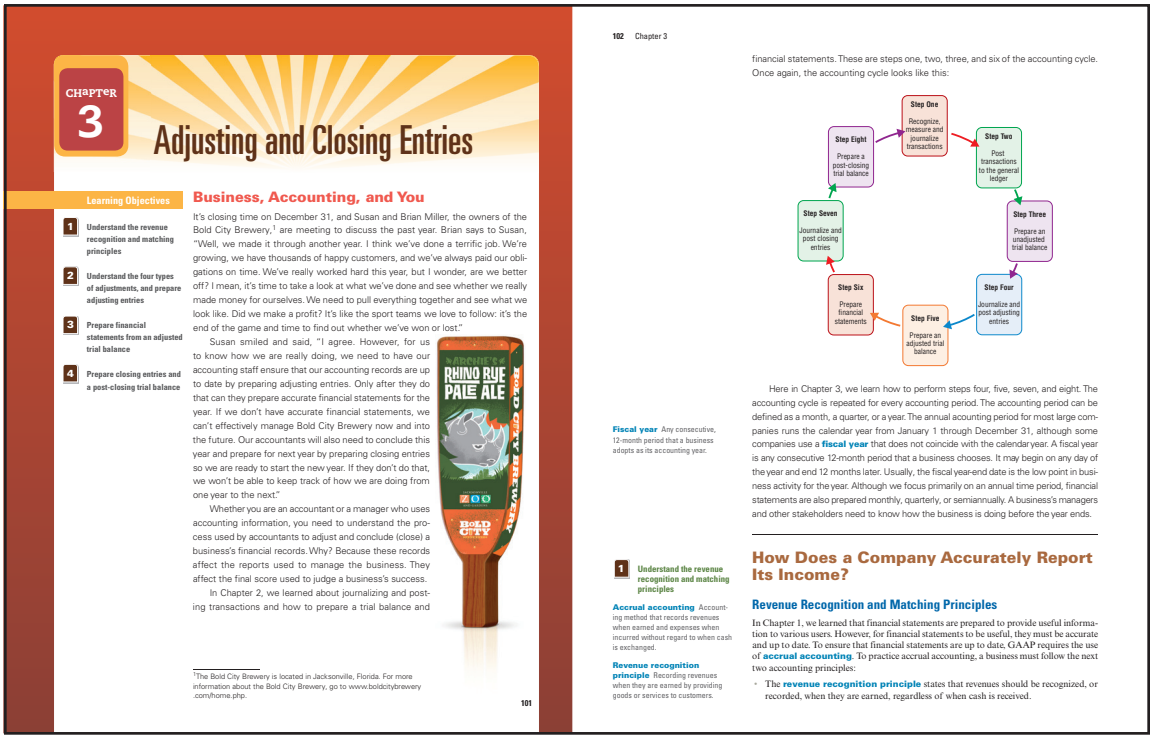
Deliver trusted content

You deserve teaching materials that meet your own high standards for your course. That's why we partner with highly respected authors to develop interactive content and course-specific resources that you can trust—and that keep your students engaged.

Chapter Openers

Bold City Brewery is discussed at the beginning of each chapter in the Business, Accounting, and You feature. This feature motivates students by tying the business concept directly to the chapter's accounting topics and demonstrating the importance and usefulness of the chapter's topics.



CHAPTER 3

Adjusting and Closing Entries

Learning Objectives

1 Understand the revenue recognition and matching principles

2 Understand the four types of adjustments, and prepare adjusting entries

3 Prepare financial statements from an adjusted trial balance

4 Prepare closing entries and a post-closing trial balance

Business, Accounting, and You

It's closing time on December 31, and Susan and Brian Miller, the owners of the Bold City Brewery,[1] are meeting to discuss the past year. Brian says to Susan, "Well, we made it through another year. I think we've done a terrific job. We're growing, we have thousands of happy customers, and we've always paid our obligations on time. We've really worked hard this year, but I wonder, are we better off? I mean, it's time to take a look at what we've done and see whether we really made money for ourselves. We need to pull everything together and see what we look like. Did we make a profit? It's like the sport teams we love to follow: it's the end of the game and time to find out whether we've won or lost."

Susan smiled and said, "I agree. However, for us to know how we are really doing, we need to have our accounting staff ensure that our accounting records are up to date by preparing adjusting entries. Only after they do that can they prepare accurate financial statements for the year. If we don't have accurate financial statements, we can't effectively manage Bold City Brewery now and into the future. Our accountants will also need to conclude this year and prepare for next year by preparing closing entries so we are ready to start the new year. If they don't do that, we won't be able to keep track of how we are doing from one year to the next."

Whether you are an accountant or a manager who uses accounting information, you need to understand the process used by accountants to adjust and conclude (close) a business's financial records. Why? Because these records affect the reports used to manage the business. They affect the final score used to judge a business's success.

In Chapter 2, we learned about journalizing and posting transactions and how to prepare a trial balance and

[1]The Bold City Brewery is located in Jacksonville, Florida. For more information about the Bold City Brewery, go to www.boldcitybrewery.com/home.php.

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financial statements. These are steps one, two, three, and six of the accounting cycle. Once again, the accounting cycle looks like this:

Step One: Recognize, measure and journalize transactions
Step Two: Post transactions to the general ledger
Step Three: Prepare an unadjusted trial balance
Step Four: Journalize and post adjusting entries
Step Five: Prepare an adjusted trial balance
Step Six: Prepare financial statements
Step Seven: Journalize and post closing entries
Step Eight: Prepare a post-closing trial balance

Here in Chapter 3, we learn how to perform steps four, five, seven, and eight. The accounting cycle is repeated for every accounting period. The accounting period can be defined as a month, a quarter, or a year. The annual acounting period for most large companies runs the calendar year from January 1 through December 31, although some companies use a **fiscal year** that does not coincide with the calendar year. A fiscal year is any consecutive 12-month period that a business chooses. It may begin on any day of the year and end 12 months later. Usually, the fiscal year-end date is the low point in business activity for the year. Although we focus primarily on an annual time period, financial statements are also prepared monthly, quarterly, or semiannually. A business's managers and other stakeholders need to know how the business is doing before the year ends.

Fiscal year Any consecutive, 12-month period that a business adopts as its accounting year.

1 Understand the revenue recognition and matching principles

Accrual accounting Accounting method that records revenues when earned and expenses when incurred without regard to when cash is exchanged.

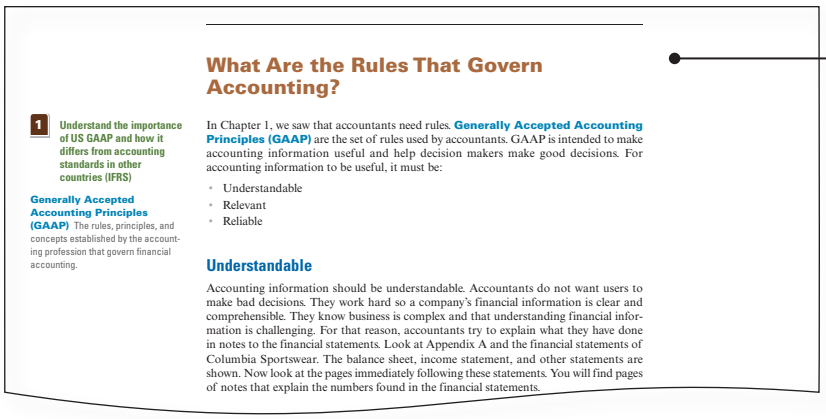
Revenue recognition principle Recording revenues when they are earned by providing goods or services to customers.

How Does a Company Accurately Report Its Income?

Revenue Recognition and Matching Principles

In Chapter 1, we learned that financial statements are prepared to provide useful information to various users. However, for financial statements to be useful, they must be accurate and up to date. To ensure that financial statements are up to date, GAAP requires the use of **accrual accounting**. To practice accrual accounting, a business must follow the next two accounting principles:

- The **revenue recognition principle** states that revenues should be recognized, or recorded, when they are earned, regardless of when cash is received.



What Are the Rules That Govern Accounting?

1 Understand the importance of US GAAP and how it differs from accounting standards in other countries (IFRS)

Generally Accepted Accounting Principles (GAAP) The rules, principles, and concepts established by the accounting profession that govern financial accounting.

In Chapter 1, we saw that accountants need rules. **Generally Accepted Accounting Principles (GAAP)** are the set of rules used by accountants. GAAP is intended to make accounting information useful and help decision makers make good decisions. For accounting information to be useful, it must be:

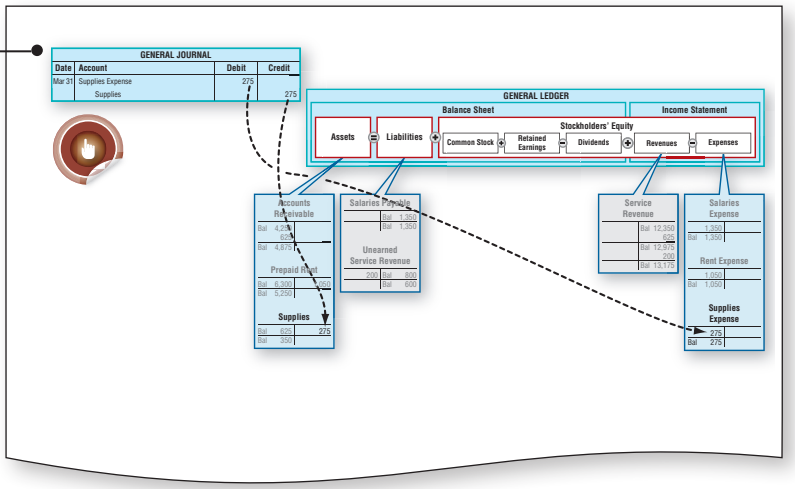
- Understandable
- Relevant
- Reliable

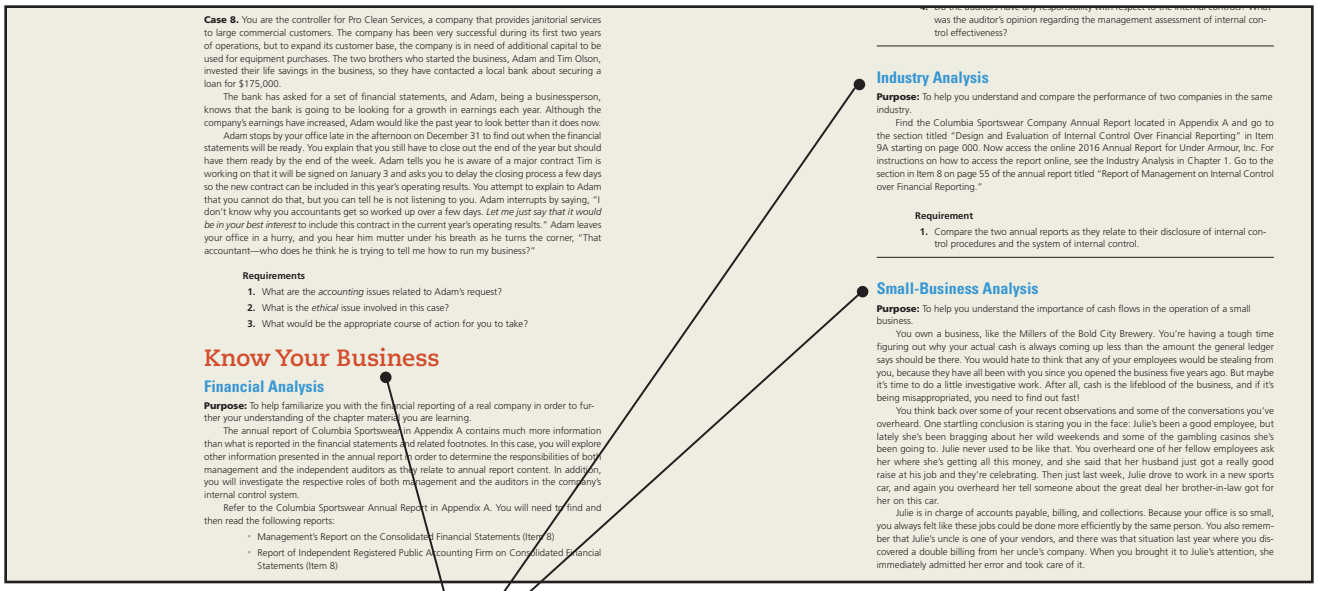
Understandable

Accounting information should be understandable. Accountants do not want users to make bad decisions. They work hard so a company's financial information is clear and comprehensible. They know business is complex and that understanding financial information is challenging. For that reason, accountants try to explain what they have done in notes to the financial statements. Look at Appendix A and the financial statements of Columbia Sportswear. The balance sheet, income statement, and other statements are shown. Now look at the pages immediately following these statements. You will find pages of notes that explain the numbers found in the financial statements.

Question-and-Answer Format mirrors those valuable, teachable moments in the classroom when a student asks a question that gets straight to the heart of the topic.

Live Examples Approach The authors introduce unique live examples to illustrate the connection between the accounting equation and journalizing transactions. In Chapters 2 and 3 of the Pearson eText, students can journalize transactions, create T-Accounts, and test their understanding of the relationship between journal entries and the accounting equation. Eighteen live examples allow students to practice over and over again until they comprehend these critical accounting concepts.





Case 8. You are the controller for Pro Clean Services, a company that provides janitorial services to large commercial customers. The company has been very successful during its first two years of operations, but to expand its customer base, the company is in need of additional capital to be used for equipment purchases. The two brothers who started the business, Adam and Tim Olson, invested their life savings in the business, so they have contacted a local bank about securing a loan for $175,000.

The bank has asked for a set of financial statements, and Adam, being a businessperson, knows that the bank is going to be looking for a growth in earnings each year. Although the company's earnings have increased, Adam would like the past year to look better than it does now.

Adam stops by your office late in the afternoon on December 31 to find out when the financial statements will be ready. You explain that you still have to close out the end of the year but should have them ready by the end of the week. Adam tells you he is aware of a major contract Tim is working on that it will be signed on January 3 and asks you to delay the closing process a few days so the new contract can be included in this year's operating results. You attempt to explain to Adam that you cannot do that, but you can tell he is not listening to you. Adam interrupts by saying, "I don't know why you accountants get so worked up over a few days. *Let me just say that it would be in your best interest* to include this contract in the current year's operating results." Adam leaves your office in a hurry, and you hear him mutter under his breath as he turns the corner, "That accountant—who does he think he is trying to tell me how to run my business?"

Requirements

1. What are the *accounting* issues related to Adam's request?
2. What is the *ethical* issue involved in this case?
3. What would be the appropriate course of action for you to take?

Know Your Business

Financial Analysis

Purpose: To help familiarize you with the financial reporting of a real company in order to further your understanding of the chapter material you are learning.

The annual report of Columbia Sportswear in Appendix A contains much more information than what is reported in the financial statements and related footnotes. In this case, you will explore other information presented in the annual report in order to determine the responsibilities of both management and the independent auditors as they relate to annual report content. In addition, you will investigate the respective roles of both management and the auditors in the company's internal control system.

Refer to the Columbia Sportswear Annual Report in Appendix A. You will need to find and then read the following reports:

- Management's Report on the Consolidated Financial Statements (Item 8)
- Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements (Item 8)

was the auditor's opinion regarding the management assessment of internal control effectiveness?

Industry Analysis

Purpose: To help you understand and compare the performance of two companies in the same industry.

Find the Columbia Sportswear Company Annual Report located in Appendix A and go to the section titled "Design and Evaluation of Internal Control Over Financial Reporting" in Item 9A starting on page 000. Now access the online 2016 Annual Report for Under Armour, Inc. For instructions on how to access the report online, see the Industry Analysis in Chapter 1. Go to the section in Item 8 on page 55 of the annual report titled "Report of Management on Internal Control over Financial Reporting."

Requirement

1. Compare the two annual reports as they relate to their disclosure of internal control procedures and the system of internal control.

Small-Business Analysis

Purpose: To help you understand the importance of cash flows in the operation of a small business.

You own a business, like the Millers of the Bold City Brewery. You're having a tough time figuring out why your actual cash is always coming up less than the amount the general ledger says should be there. You would hate to think that any of your employees would be stealing from you, because they have all been with you since you opened the business five years ago. But maybe it's time to do a little investigative work. After all, cash is the lifeblood of the business, and if it's being misappropriated, you need to find out fast!

You think back over some of your recent observations and some of the conversations you've overheard. One startling conclusion is staring you in the face: Julie's been a good employee, but lately she's been bragging about her wild weekends and some of the gambling casinos she's been going to. Julie never used to be like that. You overheard one of her fellow employees ask her where she's getting all this money, and she said that her husband just got a really good raise at his job and they're celebrating. Then just last week, Julie drove to work in a new sports car, and again you overheard her tell someone about the great deal her brother-in-law got for her on this car.

Julie is in charge of accounts payable, billing, and collections. Because your office is so small, you always felt like these jobs could be done more efficiently by the same person. You also remember that Julie's uncle is one of your vendors, and there was that situation last year where you discovered a double billing from her uncle's company. When you brought it to Julie's attention, she immediately admitted her error and took care of it.

The Perfect Balance of Small Business Perspective and Corporate Coverage Not every student will graduate and become part of a large corporation, which is why it's important for students to understand how financial accounting applies in small business scenarios as well as corporate ones.

Focus on Decision Making

"Who Owns Net Income and Where Does Net Income Go?"

What is net income? You can't touch it. You can't see it. You can't spend it. There's not even an account in the general ledger called Net Income. You can touch, see, and spend cash. But using accrual accounting, net income is not cash. So, what is net income? Net income is the net of revenues less expenses. But who gets the net income? Who owns net income?

The answer is that owners own net income. Think of revenues as something that benefits owners. Think of expenses as something that takes away some of that benefit that revenues provide. The net—whether net income or loss—belongs to the owners.

At the end of each accounting period, we want to close out the old measures and start new measures of revenues, expenses, and net income. We have closing entries that zero out all the revenue and expense accounts so they start with a zero balance. However, we do not zero out the impact that revenues and expenses had on balance sheet accounts such as cash, accounts receivable, and accounts payable. To get this to work, we must recognize that the net income belongs to the business's owners. It's a part of the owners' equity. If the business does not distribute it to the owners, the net income is retained in the business. Earnings over time can be retained in the business or distributed to owners.

How They Do It: A Look at Business

During a period of time, a business sells products and earns revenue. In doing so, it incurs expenses. Revenue less expenses is net income (or net loss). Think about a microbrewery such as the Bold City Brewery.[2] Remember in Chapter 1 that our dream brewery started with $1,500,000 in assets. It financed $1,500,000 in assets with $750,000 in liabilities and $750,000 in stockholders' equity. What did it do with its assets? During the year, it used the assets to make and sell beer. Sales were $3,000,000. It incurred expenses in making and selling the beer of $2,700,000. During the year, the brewery made its owners $300,000 in net income. The owners started with $750,000 in stockholders' equity. It increased its stockholders' equity by adding $300,000 in net income to retained earnings. Thus, at the end of the year, the $300,000 in additional retained earnings increased stockholders' equity from $750,000 to $1,050,000. If the brewery does not pay a dividend to its owners, the brewery will have ending stockholders' equity of $1,050,000. The brewery will start the next year with $1,050,000 in stockholders' equity.

Now let's look at the Walt Disney Company. Disney operates amusement parks, makes movies, sells clothing, and does many other things related to the entertain-

Focus on Decision Making shows students how to make financially sound business decisions and to evaluate risk and the impact of those decisions on a company.

Decision Guidelines focus students on key business decisions that require a firm understanding of the accounting concepts in each chapter.

Decision Guidelines

Decision	Guideline	Analyze
How can I tell how well a business is performing?	A company's financial statements provide information regarding its performance.	The income statement reflects how profitable a business has been for a specified period of time. The statement of retained earnings shows how much of a company's earnings have been distributed to the stockholders during the period. And the balance sheet reflects the business's financial position on a given date. In other words, it shows what assets the business has and who has rights to those assets.

Try It!

Jane Richards is the accountant for Crazy Curls, Inc., a local salon. After Jane finished preparing the financial statements for the year, she realized that she failed to make an adjusting entry to record $975 of depreciation expense on equipment. What effect did this error have on Crazy Curls' financial statements?

Answer

To determine the effect of omitting an adjusting entry, we must examine what the adjusting entry should have been. Jane should have made the following adjusting entry:

DATE	ACCOUNTS	POST REF.	DR.	CR.
	Depreciation Expense, Equipment		975	
	Accumulated Depreciation, Equipment			975

As we can see from the journal entry, Depreciation Expense, Equipment should have been debited (increased), which would have increased total expenses for the year. An increase in total expenses causes a decrease in Net Income. So, the omission of the adjusting entry for depreciation expense causes Net Income, and therefore Retained Earnings, to be overstated. We also see that the Accumulated Depreciation, Equipment account should have been credited (increased), which would cause total assets to decrease because Accumulated Depreciation, Equipment is a contra-asset account. So, the omission of the adjusting entry for depreciation expense also causes the total assets to be overstated.

Try It! gives students the opportunity to apply the concept they just learned to an accounting problem.

Stop and Think includes a question-and-answer snapshot asking students to apply what they just learned.

Stop and Think . . .

If cash is so important to the well-being of a business, why does US GAAP require the use of accrual accounting instead of cash accounting?

Answer

The goal of US GAAP is for financial statements to reflect accurate information regarding the performance of a business. The fact that a business has received cash from customers does not necessarily mean that the business is performing well. For example, let's assume that during the year a business received $95,000 from customers for services it had provided during the same year. The business also received another $15,000 from customers for services that will not be provided until the following year. Under cash accounting, the business would report $110,000 of revenues in the first year. Now, suppose during the second year the customers asked for (and received) a refund of the $15,000 before the services were provided. The $110,000 in revenues originally reported under cash accounting during the first year now seem inaccurate because the business only ended up with revenues of $95,000. Under accrual accounting, the business would have reported only $95,000 of revenues in the first year, which would have reflected a more accurate picture of the business's performance. This is because, under accrual accounting, revenues are recorded when they are earned instead of when cash is received.

Continuing Financial Statement Analysis Problem

Let's look at Dick's Sporting Goods (Dick's) some more. Think about Dick's. Think about accountants reporting what Dick's has, where it got its money, and what it has been doing to create value. Is Dick's earning net income or loss? What resources did Dick's need to operate? Think about the business of Dick's.

Return to Dick's financial statements, which are contained in its Annual Report (see the Continuing Financial Statement Analysis Problem in Chapter 2 for instructions on how to access the Annual Report). Go to page 40, where you will find Dick's income statement for the year ending January 28, 2017 (called the Consolidated Statement of Income). On page 42, you'll find Dick's balance sheet as of January 28, 2017. Now answer the following questions:

1. What makes up Dick's inventory? See footnote 1 of the financial statements (page 45 in Dick's 2016 annual report). What inventory method does Dick's use, for example, FIFO or LIFO?
2. Look at Dick's balance sheet. How much has Dick's invested in inventory as of January 28, 2017, and January 30, 2016?
3. Look at Dick's balance sheet. How much inventory does Dick's have per store as of January 28, 2017, and January 30, 2016? (Divide the total inventory by the number of stores Dick's operated in each of these years: 797 in 2016 and 741 in 2015.) Is inventory per store increasing or decreasing?
4. Look at Dick's balance sheet and income statement. What is Dick's inventory turnover rate for the year ending January 28, 2017? What does this tell you?
5. Look at Dick's balance sheet and income statement. What is Dick's days-sales-in-inventory for the year ending January 28, 2017? What does this tell you?
6. Looking back over your answers to questions 1 through 5, how do you think Dick's is performing?

Continuing Financial Statement Analysis Problem uses the Dick's Sporting Goods 2016 annual report to familiarize students with reading and interpreting financial statements in each chapter. By the end of the text, they have completely analyzed the financial statements.

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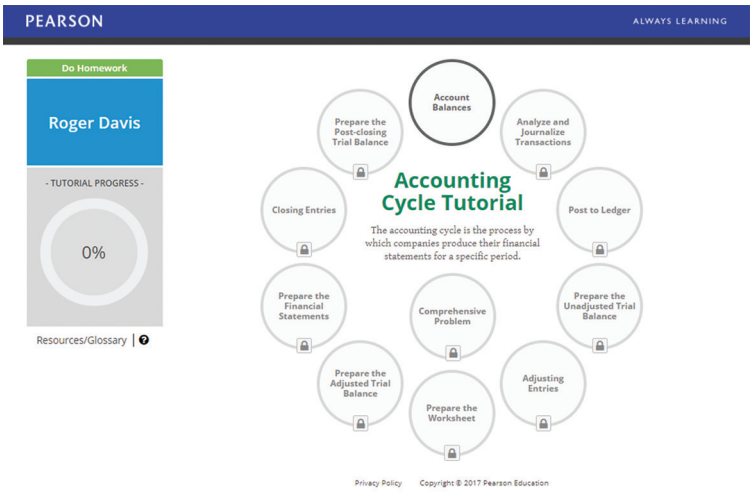
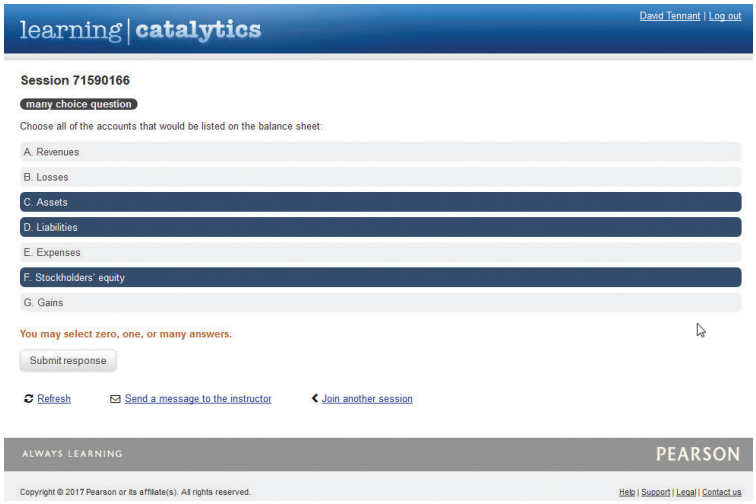


Accounting Cycle Tutorial (ACT) with Comprehensive Problem

MyLab Accounting's new interactive tutorial helps students master the accounting cycle for early and continued success in the Introduction to Accounting course. The tutorial—accessed by computer, smartphone, or tablet—provides students with brief explanations of each concept of the accounting cycle through engaging videos and animations. Students are immediately assessed on their understanding, and their performance is recorded in the MyLab Accounting grade book. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyLab Accounting to help them be successful with the accounting cycle. This updated version includes a new comprehensive problem.



Learning Catalytics

Learning Catalytics, available through MyLab Accounting, is a "bring your own device" assessment and classroom activity system that expands the possibilities for student engagement. By using Learning Catalytics, you can deliver a wide range of automatically graded or open-ended questions that test content knowledge and build critical thinking skills. Eighteen different answer types provide great flexibility, including graphical, numerical, textual input, and more.

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Instructor Teaching Resources

This program comes with the following teaching resources:

Supplements available to instructors at www.pearsonhighered.com/kemp	Features of the Supplement
Solutions Manual Created by Jeffrey Waybright	Contains solutions to all end-of-chapter questions, including short exercises, exercises, and problems.
Instructor's Resource Manual Created by Stephanie Swaim, Dallas County Community College District	**Course Content** – Introduction to the Instructor's Resource Manual with a list of resources and a roadmap to help navigate MyLab Accounting – Instructor tips for teaching courses in multiple formats: traditional, hybrid, or online – "First Day of Class" student handout that includes tips for success in the course as well as an additional document that shows students how to register and log on to MyLab Accounting – Sample syllabi for 10- and 16-week courses **Chapter Content** – Chapter overview and teaching outline that includes a brief synopsis and overview of each chapter – List of learning objectives from the text – Key topics that walk instructors through what material to cover and what examples to use when addressing certain items within the chapter – Student chapter summary handout to assist students in taking notes on the chapter – Assignment grid that outlines all end-of-chapter exercises, problems, and cases; the topic of a particular exercise, problem, or case; estimated completion time; level of difficulty; and availability in General Ledger or Excel templates – Ten-minute quizzes that quickly assess students' understanding of the chapter material
Test Bank Created by Lauren Psomostithis, North Seattle College	Includes more than 1,500 questions; both objective-based questions and computational problems are available. Algorithmic test bank is available in MyLab Accounting. *Algorithmic test bank* is available in MyLab Accounting. Most computational questions are formulated with an algorithm so that the same question is available with unique values. This offers instructors a greater pool of questions to pull from, and will help ensure each student has a different test. All questions include the following annotations: • Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis) • Type (Multiple-choice, true/false, short-answer, essay) • Learning objective • AACSB learning standard (Ethical Understanding and Reasoning; Analytical Thinking Skills; Information Technology; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)
Computerized TestGen	TestGen allows instructors to: • Customize, save, and generate classroom tests • Edit, add, or delete questions from the Test Item Files • Analyze test results • Organize a database of tests and student results

Supplements available to instructors at www.pearsonhighered.com/kemp	Features of the Supplement
PowerPoints Created by Ferdinand Siagian, Minnesota State University	These presentations help facilitate classroom discussion. – *Instructor PowerPoint Presentations* with lecture notes – *Student PowerPoint Presentations* – *Image Library* contains all image files from the text to assist instructors in modifying our supplied PowerPoint presentations or in creating their own PowerPoint presentations.
Working Papers Created by Stephanie Swaim, Dallas County Community College District	Available in both Excel and PDF format, these documents can be used for completing end-of-chapter questions in preformatted templates.

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MyLab Accounting online Homework and Assessment Manager includes:

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- The Excel in Practice Data Files, related to select end-of-chapter problems
- Working Papers, for completing end-of-chapter questions in preformatted templates
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CHAPTER 1

Business, Accounting, and You

Learning Objectives

1. Understand the nature of business and the role of accounting in business
2. Know how a business operates
3. Describe the different types and forms of businesses
4. Identify the key accounting principles and concepts
5. Explain how accounting functions in a business
6. Understand and be able to prepare basic financial statements

Business, Accounting, and You

Imagine you own or manage a business. Think about creating a product that customers want and value. Dream about building a business that creates value for owners and other stakeholders. Now ask yourself, "What will it take to make my dream come true?" You need good employees. You need assets such as supplies, equipment, and inventory. You need money to finance your operations and assets.

Susan and Brian Miller were just like you. They had a dream. They wanted to create something special: a microbrewery that created value for customers, themselves, employees, and others. To be successful, they realized they needed employees, assets, and financing. But they also needed information. Information would enable them to hire and manage their employees, acquire and manage their assets, and finance their business. When the Millers created the very successful Bold City Brewery,[1] they knew they needed good information about the business's operations, assets, and financing. To have this critical information available, they needed a good accounting system.

So what is accounting? Why is accounting so important? Why does the study of business typically start with accounting?

Accounting is the language of business. Imagine living in a foreign country and not being able to speak the native language. It would be very hard. Accounting is the process businesses use to communicate what they've got in the way of resources, where they got the money to acquire the resources, and what they've been doing with the resources. To be successful in business, you need to be able to understand, speak, and use the language of business.

Accounting is also the scorekeeping function of a business. Think of the last sporting event you watched or played. Think about a game or contest where nobody kept score. Can you imagine the end of the game without

[1]The Bold City Brewery is located in Jacksonville, Florida. For more information about the Bold City Brewery, go to www.boldcitybrewery.com/home.php.

knowing who scored, when they scored, and even how they scored? Accounting lets business managers know whether they are winning or losing.

The bottom line is, accounting is at the heart of business. Understanding the foundation and process of accounting is critical to success in the business world. To be successful like the Millers, you must start with accounting. At the beginning of each chapter is a section titled Business, Accounting, and You, where we focus on how accounting keeps track of a business's transactions and helps people like you make good business decisions. We'll use the Bold City Brewery to show the importance of the chapter topic. At the end of the chapter is a section titled How They Do It: A Look at Business. Here, we look at how businesses like the Bold City Brewery use the chapter topic to manage the business.

What Is a Business, and Why Study Accounting?

1 Understand the nature of business and the role of accounting in business

Accounting The process of recognizing, measuring, recording, and reporting information about a business's transactions.

You want to be successful in business. But why study accounting? The answer is what accounting reveals. **Accounting** is the process of recognizing, measuring, recording, and reporting information about a business's transactions. Understanding accounting enables you to recognize and understand business transactions. Understanding business transactions enables you to manage them successfully.

Think about going to a sporting event where you know nothing about the sport. You would probably have many questions. Your questions might include:

- What is the objective of this sport?
- Who are the players, and what are they doing to compete?
- How do players win or lose the competition?
- Who keeps score, and how is the score kept?

Business is a competition. Businesses compete for customers, employees, profits, and much more. To successfully compete in business, you need to understand the objective of business, the players and their roles in business, the rules of business, and who keeps score and how it is kept.

If accounting is the scorekeeper of business, let's first talk about the game of business. When you look at business, you see people and organizations creating, producing, and selling products. Businesses, both for-profit and not-for-profit, are everywhere. But have you ever stopped and thought about business? Think about it. What is a business? Why does a business exist? How does a business operate?

The Definition of a Business

Business A legal organization that attempts to create value by exchanging products with customers for money.

Product A good or service purchased or produced by a business to be sold.

Goods Physical items that can be touched and felt.

Services Activities that exist but cannot be touched and felt.

A **business** is a legal organization that attempts to create value by exchanging products with customers for money. An organization must have three elements to be called a business:

1. *Businesses are legal entities.* Businesses are empowered by law to operate.
2. *A business must exchange a* ***product***, often referred to as either a good or a service, for money or money substitutes.
   a. **Goods** are physical items we can touch and feel. Examples include food, cars, and clothing.
   b. **Services** are activities that we know exist but we cannot touch and feel. Examples include medical services, car repairs, and education.

However, providing products is not a sufficient criteria for an organization to be called a business. Someone must buy these products for money or money substitutes (for example, a receivable or promise to pay later). So, who buys the products for money or money substitutes? The answer is **customers**. To succeed, a business must create an exchange with a customer. The exchange is called a **sale**.

Customer A person or organization that purchases a product from a business.

Sale The exchange between a business and a customer whereby the business provides a product to the customer and the business receives money or money substitutes.

3. *Businesses create value.* Customers get value from the benefits of a product; however, the other stakeholders in a business should also receive value. Owners get value from the profits a business earns. Employees get value from their wages. Lenders get value from the interest they charge.

The purpose of any business is to create and increase value. In a for-profit business, this value is often measured as the market price of the business, or what you'd pay if you wanted to buy and own the business.[2] All too often, people assume that a business exists to create products, sales, profits, and jobs. All these things are important; however, the purpose of a business is to create value. So what is value? What determines value? How does value differ from profit?

The General Concept of Value

Value The price someone is willing to pay for an item.

The **value** of an item is what someone is willing to pay for it. As such, value depends on:

1. What the owner of an item expects to receive
2. When the owner expects to receive it
3. How certain the owner is about what he or she will receive and when it will be received

For example, imagine you plan to cook a very special dinner tonight for a very special person. You need groceries. Where do you go? You think of a grocery store such as Kroger. It's late in the day, and you need food now. You are certain that Kroger will have the food you want and need. So what are you doing? You are entering into an exchange with Kroger. Kroger will provide you food and you will pay Kroger money.

When we go to make an exchange, we seek one where *the value we receive exceeds the value we give up*. In other words, we want a "good deal." In the Kroger example, you go to the store and ask the grocer how much you would pay for its food. If you believe the value of Kroger's food is greater than the value of the money you must pay, you agree to the exchange. If you believe the value of Kroger's food is less than the value of the money you must pay, you keep your money and do not agree to the exchange. You're basically comparing the value of the food and the value of the money, seeking the greatest value for yourself.

Cost The amount of money or money substitutes a business pays to receive an item used in operating a business.

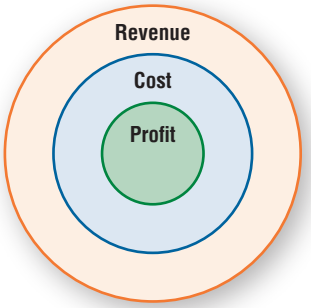
Revenue The amount of money or money substitutes a business receives from the sale of a product.

Profit The revenue from a sale less the cost of the sale.

Businesses behave in the same way. A business attempts to create value by exchanging a product with a customer. Businesses buy or make products at one value (**cost**) and try to sell these products to their customers at a higher value (**revenue**). This exchange creates a **profit** (net benefit) to the business. An example of this is Kroger's grocery business. If done well, Kroger makes a profit by paying less for the food (cost) than it charges you for the food (revenue). Making a profit is very important in a for-profit business and drives the value of the business. Accountants are responsible for measuring revenue, costs, and profits.

In addition to the amount of profit, businesspeople also worry about *when* they make a profit and the *risk* they take in order to generate a profit. As we'll learn in later chapters, the old adage "time is money" is true. Time does affect the value of an item. The quicker a business like Kroger earns a profit, the more valuable it is. The longer a business takes

[2]For-profit businesses attempt to earn a profit. The concept of profit is discussed later. Examples of for-profit businesses are Target, Southwest Airlines, and many smaller businesses in your community. Not-for-profit businesses attempt to break even, experiencing neither profit nor loss. Examples of not-for-profit businesses are charities, governments, and religious organizations. This text focuses on for-profit businesses; however, many of the concepts discussed are applicable to not-for-profit businesses.



to earn a profit, the less valuable it is. Think about it. Would you pay extra to have Kroger prepare your special meal? The answer is probably yes, given that it is late in the day. As we'll discuss throughout the book, accountants worry about *when* to recognize business transactions such as revenue, cost, and profit.

Risk The uncertainty that an undesired outcome could result.

Loss A negative profit that occurs when the cost of a sale is greater than the revenue from the sale.

Risk is also important. **Risk** is the uncertainty that an outcome we do not expect or desire could result. An example is Kroger's success. Do the owners of Kroger know their business will succeed? The answer is they hope and believe Kroger will succeed but are not certain of its success. Think about Kroger's grocery business. What happens if you and others do not buy Kroger's food? Kroger incurs a **loss**, where revenue is less than cost. If Kroger continues to lose money, it will fail. Risk hurts value. Businesspeople must recognize, understand, measure, and manage risk. To compensate for taking a risk, businesses expect higher profits. Accountants help managers and other decision makers understand risk with accounting information. An example of such accounting information is whether a business can pay its debts on time or at all. In every chapter, specifically in Chapter 12, Financial Statement Analysis, we'll see how accounting information helps managers and other stakeholders understand risk.

Business Owners and Other Stakeholders

Stakeholder A person or organization affected by a business.

A business has many **stakeholders**, or people and organizations affected by a business. These stakeholders include customers, employees, suppliers, regulators, society, lenders, and owners. All stakeholders are important. All stakeholders should believe they are receiving value from the business. In other words, each of the stakeholders in a business gives and receives value through an exchange. Ideally, each stakeholder believes the value he or she receives exceeds the value he or she gives up. An employee gives a business his or her labor for a paycheck. A supplier sells products to a business, ideally at a profit. A customer buys a product from a business at a price. Society, and regulators appointed by society, benefit from a business through jobs, taxes, and hopefully a good quality of life. In a free-market economy, all stakeholders are free to enter into an exchange, are important, and should not be taken for granted.

However, those who provide money are free to do so as they deem appropriate. Nobody forces a bank to make a loan to a business. Nobody forces an owner to put money in a business. There is an old saying: "It takes money to make money." That means it takes money to form and operate a business. To attract that money, lenders and owners must believe they will receive value greater than they give.

The Goal of a Business

The goal of a business is to create value for its owners. Owners expect a profit that compensates them for the use of their money over time and for the risk they assume. If the business does not create value, owners will not provide the money needed to operate the business. Without the business, customers, suppliers, employees, and society will not receive the value they seek. A business must create value for its owners. To do so, however, owners must appreciate that the other stakeholders must also receive value.

So if the objective of a firm is to create value, and we need to focus on creating value for owners, how does a business create value for its owners? How does a business generate profits, over time, in the presence of risk?

How Does a Business Operate?

2 **Know how a business operates**

Operating a business is not simple or easy. It takes a lot of resources. It also takes the ability to use those resources wisely. So what are the resources a business needs, and how does a business use those resources to generate profits, over time and at risk?

Resources Needed to Start and Operate a Business

To operate, businesses need to acquire money and use that money to make a profit. A firm acquires money by:

1. Borrowing money from lenders (called **liabilities**)
2. Getting owners to put in their money (called **stockholders'** or **owners' equity**) in exchange for a percentage of ownership

Liabilities Amounts owed to lenders or other creditors.

Stockholders' equity Money provided to a business by owners through either an initial investment or the retention of profits; also known as **owners' equity**.

A liability is a financial claim, or debt, that the business owes to a party that is not an owner of the business. Owners' equity represents money provided to the business by owners, through either an initial investment or the retention of profits. Often people say the owners *invested* their money in the business.

Operating a Business

A business then uses the money to acquire assets and hire people. An **asset** is an economic resource that a business owns and can use to operate. Assets include things such as cash, supplies, inventory, and buildings. The business also hires people, called **employees**, to operate the business for a period of time.

With assets and employees, the business operates with the hope of generating a profit, where revenue is greater than expenses. Remember, revenue is money or other value received that a business earns from the sale of goods or services. **Expenses**, often referred to as costs, are money or other value surrendered in the operation of the business. Part of operating a business is making sure lenders are paid interest. **Interest** is the expense of using borrowed money for a period of time.

After paying interest and other expenses, the owners of the business get what remains, referred to as profit or **net income**. Net income is revenue less expenses (including interest expense).[3]

Asset An economic resource that a business owns and can use to operate the business.

Employees People hired by a business to operate the business for a period of time.

Expense Money or other value surrendered as a result of the sale of goods or services or the operation of the business.

Interest The expense of using borrowed money for a period of time.

Net income Operating profit less interest expense, computed as revenue, less operating expenses, less interest expense.

$$\text{Net Income} = \text{Revenue} - \text{Expenses}$$

The question that owners must ask is whether the net income is worth the time and risk involved. Owners have many alternative uses for their money. They, like everyone else, seek the greatest value or return on their money.

Let's look at a simple example. You start a computer repair business. You invest $1,000 in your business, which will be used to start the business and is called owner's equity. You expect net income of $100, or a 10 percent return on your money ($100/$1000). However, you need $2,000 to purchase equipment and other assets in order to start your business. You

[3]A business must also pay taxes. Taxes are expenses that are explored later in this book. Net income is what is left after a business recognizes its tax expenses and other expenses.

go to a bank and ask to borrow $1,000 for one year. The bank looks at your loan application and agrees to lend you $1,000. However, for the time and risk associated with your loan, the bank requires you to pay simple interest of 6 percent. Thus, in one year you are required to repay the $1,000 loan plus $60 (6 percent) interest, or a total of $1,060. You borrow the $1,000 from the bank, combine it with your $1,000 equity, and start your business.

After one year, you close and liquidate the business. You are proud of your business because you have worked hard. You had revenue of $500, expenses such as supplies and rent of $400, and interest expense of $60 (6% × $1,000). You made net income of $40 ($500 − $400 − $60 = $40). The revenue from these sales exceeded the expenses by $40. How do you feel? Net income of $40 is good, but is it good enough? Would you have invested your $1,000 in the business if you thought you would only earn net income of $40?

The Cost of Money

Creating value is more than just generating net income by selling a product. Money has a cost. Businesses get money by borrowing it or having owners provide it. If a business borrows money, it must pay the lender "rent" on the money, called interest. It must also return the borrowed money at an agreed-upon time in the future. However, owners' money also has a cost. Owners are not going to provide their money without expecting to receive a benefit, or return, over time. Why should they? Why would an owner put money in a business for no return when they could deposit their money in a bank and earn interest? Never forget that money, whether borrowed or provided by owners, has a cost. The cost of money is dependent on many things, but above all else it is a function of the risk the lender or owner is taking. Remember: Great risk must be compensated by great return.

We just learned that a business first acquires money from lenders (liabilities) and owners (equity). Lenders require the business to pay interest and return the money they borrow. Owners expect to receive a benefit or return. This benefit or return is based on net income. Then a business uses the money to hire employees and acquire assets. Next, the employees use the assets to generate net income. If successful, the net income is equal to or exceeds the net income expected by owners. When it does, value for the owners is created. When it does not, value for the owners is lessened.

How Are Businesses Organized?

3 **Describe the different types and forms of businesses**

Many types and forms of business organizations exist. The type of business relates to what it does to create value or, in other words, to make a profit. The form of business organization relates to how it is legally organized.

For-profit business A business that attempts to create an exchange, or sale, wherein revenue exceeds expenses, creating a profit.

Not-for-profit business A business that attempts to create an exchange or sale wherein revenue equals costs.

Service business A business that sells a service to its customers.

Merchandise business A business that sells physical goods or products to its customers.

Manufacturing business A business that produces the physical goods that it sells to its customers.

Types of Businesses

Businesses are typically divided into two broad categories: for-profit businesses and not-for-profit businesses. In this book, we focus on for-profit businesses that operate as corporations.

- **For-profit businesses** attempt to create an exchange or sale wherein revenue exceeds expenses, creating a profit. Examples of for-profit businesses are Kroger, Facebook, Ford, Walmart, and Apple.
- **Not-for-profit businesses** attempt to create an exchange or sale wherein revenue equals costs. Examples of not-for-profit businesses are charities such as the Red Cross or Habitat for Humanity, religious organizations, and governments. Although not-for-profit businesses are not the focus of this book, many of the principles and techniques we discuss also apply to not-for-profit businesses.

Within these two broad categories of businesses are three types of businesses: **service businesses**, **merchandising businesses**, and **manufacturing businesses**.

- A service business sells services to its customers. In other words, it sells time. Common types of service businesses include law firms, accounting firms, physical therapy offices, painting companies, and automotive repair shops.
- A merchandise business sells physical goods or products to its customers. Common types of merchandise businesses include grocery stores, automobile dealerships, and sporting goods stores. A merchandise business may be either a wholesale business or a retail business. A **wholesale business** is a business that sells products to other businesses for resale. A business that sells food products to a grocery store is an example of a wholesale business. A **retail business** is a business that sells products to the final consumer of the product. Target, Macy's, and Kroger are examples of retail businesses.
- A manufacturing business produces the physical goods that it sells to its customers. Common types of manufacturing businesses include automobile manufacturers, clothing makers, and soft drink manufacturers.

Wholesale business A business that sells products to other businesses for resale.

Retail business A business that sells products to the final consumer of the product.

Legal Forms of Businesses

A business can be legally organized as a sole proprietorship, partnership, corporation, or limited liability company. Most businesses in the United States are sole proprietorships; however, most business transactions are conducted within and among corporations. Why? The answer is most large businesses like Kroger, Facebook, Ford, Apple, and Target are corporations. But how do you know what type of business organization is best for your business?

- A **sole proprietorship** is a business entity that has one owner. For legal purposes and for tax purposes, the business and the owner are considered the same. The business owner is personally responsible or liable for all of the debts and obligations of the business. If somebody wants to sue the business, he or she would have to sue the owner. In addition, all of the income or loss generated by the business is reported on the owner's personal tax return and taxed at individual rates.
- A **partnership** is very similar to a sole proprietorship except that it has two or more owners. For legal purposes, the owners (partners) and the business are considered the same. If somebody sues the business, he or she would need to sue the business owners. For tax purposes, the partners divide all of the income or loss of the partnership and report it on their personal tax returns. Therefore, it is taxed at individual tax rates just like a sole proprietorship.
- A **corporation** differs from a sole proprietorship or a partnership because it is a separate legal entity from the owners. The business is incorporated under the laws of a state. When you see the abbreviation "Corp." for "Corporation" or "Inc." for "Incorporated," the business is a corporation. The owners of a corporation and the corporation itself are considered separate under the law. This legal separation is very attractive to the business owners because it limits their personal liability to what they have invested in the corporation. The corporation's debts and obligations are not the debts and obligations of the owners. For tax purposes, the corporation is taxed as a separate entity from the owners. Therefore, income tax is imposed on the income of the corporation at corporate tax rates. If the business chooses to pay owners, called **stockholders**, any of the current or past net income, the business will pay a **dividend**. Stockholders must pay a tax on the dividends they receive. In effect, the income is taxed twice, double taxing the business owners. Many business owners desire to have the legal protection that the corporate form of organization offers. Owners can only lose what they have invested. They thus have limited liability. But they do not want to be subject to the "double taxation" that also occurs. Owners of small corporations are able to make an **S-corporation** election, which allows them to have limited liability and be taxed at individual rates, eliminating the double taxation.
- A **limited liability company** is a relatively new form of business organization. When you see the letters "LLC," the business is a limited liability company. The owners of a limited liability company enjoy the same legal separation that a corporation provides. For tax purposes, a limited liability company's income is treated similar to that of a sole proprietorship or a partnership. All of the income of the limited liability

Sole proprietorship A business entity that has one owner and, for legal and tax purposes, the business and the owner are considered the same.

Partnership A business that has more than one owner and, for legal and tax purposes, the business and the owners are considered the same.

Corporation A legal entity, chartered under state law, empowered to conduct business; the corporation and owners are considered as separate for legal and tax purposes.

Stockholder An owner of part of a corporation.

Dividend The payment of past and current profits, less losses, previously retained in the business.

S-corporation A small corporation that has met the legal requirements to act as a corporation but elected to be taxed at individual rates.

Limited liability company A hybrid business entity having characteristics of both a *corporation* and a *partnership*.

company is divided among the owners and is taxed at their personal rates. In many ways, a limited liability company is similar to an S-corporation. Unlike an S-corporation, however, a limited liability company can be very flexible in how it distributes earnings among the owners.

Exhibit 1-1 summarizes the different types of business organizations.

Although the process of accounting for the different types of business organizations is similar, it varies slightly depending on the type of organization. In this book, we focus our attention on accounting for corporations.

Exhibit 1-1

Type of Business	Legal Status	Tax Status	Benefits	Drawbacks
Sole Proprietorship	Business and owner are considered to be the same entity	Business income is allocated to the owner and taxed at owner's personal tax rate	• Ease of formation • No double taxation	• Unlimited liability of owner • Difficult to raise capital • Limited life
Partnership	Business and owners are considered to be the same entity	Business income is allocated to the owners and taxed at owners' personal tax rates	• Ease of formation • No double taxation • Shared investment/knowledge	• Unlimited liability of owners • Disagreements between partners • Limited life
Corporation	Business and owners are considered to be **separate** entities	Business income is taxed at corporate tax rates. Any income distributed to the owners is also taxed at owners' personal tax rates. Also referred to as a C-corporation.	• Limited liability of owners • Easier to raise capital • Unlimited life	• More difficult and costly to form • Double taxation • More paperwork • More regulations
S-corporation	Business and owners are considered to be **separate** entities	Business income is allocated to the owners and taxed at owners' personal tax rates	• Limited liability of owners • No double taxation • Easier to raise capital • Unlimited life	• More difficult and costly to form • More paperwork • More regulations
Limited Liability Company	Business and owners are considered to be **separate** entities	Business income is allocated to the owners and taxed at owners' personal tax rates	• Limited liability of owners • No double taxation • More flexibility than with S-corporation	• More difficult and costly to form • Limited life

Decision Guidelines

Decision

What form of business organization should be chosen?

Guideline

A business can be organized in many ways, including a sole proprietorship, partnership, corporation or S-corporation, or limited liability company. Each type of business organization has different advantages and disadvantages.

Analyze

Know the tax and legal treatments of each type of organization. Weigh the best treatment of taxes and legal liability of each type, and pick the format most advantageous for the business owners.

What Is Accounting, and What Are the Key Accounting Principles and Concepts?

4 **Identify the key accounting principles and concepts**

Have you noticed how many kids play little league sports these days and wondered why so many kids compete in these sports? Some children play to get into better shape and some play just for the fun, but most of them play because they want to win. We live in a very competitive world. This competitiveness makes the job of the scorekeeper very important because, without the scorekeeper, nobody would know which team won the contest. In addition to keeping track of who wins, the scorekeeper in an athletic contest tracks many other statistics that help the coaches and the players judge individual performances.

The world of business is very much like little league sports. Businesses exist to win, which is usually defined as generating profits and creating value. **Financial accounting** is the process of recognizing, measuring, recording, and reporting information about a business's transactions to stakeholders outside the business. Outside stakeholders include stockholders (owners) and lenders.

Financial accounting The process of recognizing, measuring, recording, and reporting information about a business's transactions to stakeholders outside the business, including stockholders (owners) and lenders.

So what does it take to make a business "win" and create value? It takes many hard-working people performing the functions of the business. It takes people developing great products (for example, the research and development group or department); making great products (for example, the production or operations group or department); promoting, selling, and distributing products (for example, the sales and marketing group or department); and acquiring money (for example, the finance department). But it also takes people providing information about the business's financial condition and operations. Businesses run on information, and accounting is at the heart of providing useful information. In essence, accountants are the scorekeepers in the business world.

Generally Accepted Accounting Principles

In sports, established rules and principles dictate how each game is to be played and how the score is to be kept. In the same way, the accounting profession has created a set of rules and principles that must be followed. This set of rules is codified and called **Generally Accepted Accounting Principles (GAAP)**.

Generally Accepted Accounting Principles (GAAP) The rules, principles, and concepts established by the accounting profession that govern financial accounting.

In the United States, financial accounting must follow GAAP, which is the set of rules, principles, and concepts established by the accounting profession that govern financial accounting. GAAP helps existing and potential owners and creditors compare different companies. In the United States, most GAAP is developed by the **Financial Accounting Standards Board (FASB)**. The FASB is a seven-person group primarily responsible for the establishment of GAAP. The main objective of financial accounting is to provide information useful for owners and lenders. To be useful, information must be understandable, relevant, and reliable; GAAP tries to ensure that accounting information follows these principles.

Financial Accounting Standards Board (FASB) A seven-person group primarily responsible for establishing the standards of financial accounting and reporting called GAAP.

International Financial Reporting Standards

The globalization of business means that companies outside the United States are not required to follow US GAAP. Therefore, what principles do companies based outside the United States follow to ensure the reliability of accounting information to investors and other stakeholders? **International Financial Reporting Standards (IFRS)** are accounting standards developed by the International Accounting Standards Board. IFRS were originally followed by businesses located in countries that did not have their own accounting standards. However, many countries that have their own accounting standards have started to allow the use of IFRS in addition to, or instead of, their own standards. The United States is currently considering a switch from US GAAP to IFRS. However, because the adoption of IFRS by the United States is not certain and would be years away, we focus on US GAAP. Chapter 6 has a more in-depth discussion of IFRS.

International Financial Reporting Standards (IFRS) Accounting standards developed by the International Accounting Standards Board for use throughout the world.

The Business Entity Principle

Business entity principle Dictates that the financial affairs of a business organization must be kept separate from the personal financial affairs of the business owners.

The most basic concept in accounting is that of the **business entity principle**. The business entity principle dictates that the financial affairs of a business organization must be kept separate from the personal financial affairs of the business owners. This separation is necessary because if the owners of a business choose to place personal assets into the business, then those assets are now considered to belong to the business and no longer to the owners. For example, if a business owner invests a used car into his or her business, that car should no longer be used by the business owner for personal purposes.

The Reliability (Objectivity) Principle

Reliability principle Requires information to be verifiable, confirmable by any independent observer; also called the objectivity principle.

The **reliability (or objectivity) principle** requires that the accounting information for a business be arrived at objectively so it may be relied on by outside users. The information should be independently verifiable. For example, a company's checking account is supported by a statement from the bank. This statement provides objective evidence that the account exists. Without the reliability principle, accounting information might be based on what people think or feel it should be, rather than what it really is. This would make it easier to manipulate the information for fraudulent purposes.

The Cost Principle

Cost principle States that when a business acquires assets or services, they should be recorded at their actual, or historical, cost.

Actual cost Actual cost of assets and services acquired; also referred to as **historical cost**.

The **cost principle** states that when a business acquires assets or services, they should be recorded at their **actual cost**, also called **historical cost**. In other words, the amount paid for the asset or service is the amount recorded as its value. Other values, such as market value and appraised value, are not used even if they are known at the time of the purchase. The cost principle also requires that the accounting records keep the historical cost of an asset throughout its useful life because this cost is a reliable measure.

Accounting Ethics: A Matter of Trust

Accountants are important. They have considerable responsibility and thus power. They must worry about providing information that is understandable, relevant, and reliable. Stakeholders use the information provided by accountants to make very serious business decisions. Accountants must be trustworthy and perform their accounting duties in accordance with high ethical standards. They must provide clear and complete information, not manipulate the financial information so as to mislead stakeholders, and make their best efforts to prevent fraud.

Think about a sports event. Whom do you ask to be the scorekeeper? First, you figure out who understands how the game is played. From that group, you ask the most trustworthy person available to keep score. Business is the same. Accountants must be knowledgeable, but they must also be trustworthy. In Chapter 6, we'll explore the challenges faced by the accounting profession, including ethics.

Accounting in Your World

How would you respond to the following situations?

- The company CEO asks you to falsify the company's accounting records. He or she says that the company cannot afford to report that it is performing poorly. If it does, some stores will likely have to be closed and people will lose their jobs. The CEO implies that if you are not a "team player" and fail to falsify the records, then it will be your fault these people are unemployed.

- At the end of the month, your supervisor asks you to create fictitious sales invoices. He or she tells you that your department is just a little bit shy of reaching the sales goal necessary for each member of the department to receive a quarterly bonus. Your supervisor says that you can just delete the fictitious sales at the beginning of the next month and that no one will ever know.
- A coworker confides that he or she has stolen several pairs of sunglasses from the mall kiosk at which you work. Your coworker offers to give you a pair of sunglasses. He or she says that you both deserve it for all of the long hours you have worked for the company lately.

You may find yourself faced with an ethical dilemma at any time during your career. You have only one chance to make the right decision.

What Is the Role of Accounting in a Business?

5 **Explain how accounting functions in a business**

Remember our sports analogy where the accountant is the "scorekeeper" of business? Accountants must:

- Recognize business transactions
- Measure business transactions
- Record business transactions
- Report business transactions over a period of time

Now, let's look more closely at what these scorekeeping activities are and how they are done.

The Roles of Accounting in Business

How Do You Recognize a Business Transaction?

Accountants must first recognize a business transaction. This may seem easy, but often it is not. Let's look at an example. You own a computer repair store. A customer brings in a computer for repair. Is this a sale that generates revenue? The customer promises to pay you $100 when you complete the repair. However, you have not repaired the customer's computer. There is no exchange. You have not earned the revenue yet. The customer's order is an important event, but it is not a completed business transaction. Thus, the accountant will wait to recognize this as revenue until you repair the customer's computer and earn the revenue.

Let's look at another example. Imagine you repair the customer's computer. You have completed your part of the transaction. But you have an agreement with your customer that he or she does not have to pay you for 30 days. In other words, you exchanged your repair service for the customer's promise to pay you $100 in 30 days. You have exchanged your repair service for a receivable. Is this $100 revenue when you repaired the customer's computer? Do we wait until you receive the $100 cash before we recognize the revenue?

Cash Accounting

Cash accounting Accounting that recognizes business transactions only when cash is received or disbursed.

Cash accounting recognizes a business transaction only when cash is received or disbursed. If your computer repair store used cash accounting, you would not recognize the revenue until you received the cash. However, most businesses do not use cash accounting. Most businesses, in accordance with GAAP, use accrual accounting.

Accrual Accounting

Accrual accounting Accounting that recognizes a business transaction when it occurs, whether or not cash is received or disbursed.

Accrual accounting recognizes a business transaction when it occurs, whether or not cash is received or disbursed. Using accrual accounting, your computer repair store would recognize the revenue when you repaired the customer's computer. You repaired the computer and were paid with a promise for the services performed. You now have money owed to you from the customer. You have completed a business transaction. When the customer pays you the $100, you would recognize another transaction where you now have $100 cash and no promise of future money.

Understanding when a business receives and disburses cash is very important. A business must be able to manage its cash flow in order to pay its bills and survive. However, waiting to recognize a business transaction until cash is received or paid can deny stakeholders very important information. An example is a liability. Just because a business has not paid a bill does not mean it does not owe it. Stakeholders want to know what a business owes now and must pay in the future. For that reason, businesses typically use accrual accounting. However, as noted later, accountants also provide users information about where a business gets and how it uses its cash.

How Do You Measure a Business Transaction?

After recognizing a business transaction, the accountant must then measure the transaction. This process presents several challenges.

Let's return to our example of your computer repair store. You repaired your customer's computer, and he or she now owes you $100. Will you collect $100? You may not collect the $100. Based on prior experience, you may believe that you will only collect 90 percent of the money, or $90. You estimate that you will not collect, and thus lose, $10 of the sale. Do you disclose that you are owed $100 or expect to receive $90? Under US GAAP, you would estimate that you will lose $10 and your claim on your customer is worth only $90. Measuring transactions using accrual accounting requires the accountant to make estimates. These estimates may need to be adjusted over time.

Let's look at another example. You bought a building to house your computer repair store. The building cost you $100,000 five years ago. You still own and use the building, but the building was recently appraised to have a value of $200,000. Your wealth has increased by $100,000 because your building appreciated from $100,000 to $200,000 in value. But do accountants recognize this increase in value? The GAAP used in the United States would not. Why? Because US GAAP is conservative, it requires a sale of the building to recognize that it is now worth more than when you bought it. US GAAP is based on historical cost and is designed not to overstate the value of assets. However, accounting rules in other countries may be different from US GAAP. They may recognize that the value of your building has increased even without a sale. Such rules are based on current or market values for assets. IFRS is a set of accounting rules that uses current or market values. In this book, we focus on US GAAP. However, in other chapters, particularly Chapter 6, we'll consider how different countries can have different accounting rules. *This coverage in other chapters will be denoted by the icon at left*.

How Do You Record Business Transactions Using the Accounting Equation?

Accounting is the process of recognizing, measuring, recording, and reporting information about a business's transactions. But what process or method do accountants use? After business transactions are recognized and measured, how do accountants record the business transactions?

Remember, an accountant's job is really being the scorekeeper for a business. An accountant needs to keep track of information so he or she can tell people about the operations of the business. An accountant must keep track of two main things. First,

the accountant must track the resources a business owns that have value. These are called assets. In addition, the accountant must track where the business obtained the money to finance its assets. Remember, money comes from liabilities or stockholders' equity. The amount of assets a business owns at a point in time must equal the amount of financing the business has at that point in time. In other words, assets must equal liabilities plus stockholders' equity. This concept can be expressed as an equation, referred to as the **fundamental accounting equation**:

Fundamental accounting equation The equation that total assets equal the sum of total liabilities and total stockholders' equity.

(what the business owns) (who provides the money)

The parties who provide the money to finance a company's assets have an ownership interest in the assets of the company. Therefore, the liabilities and stockholders' equity also represent who has an ownership interest in, or claims to, a company's assets.

Transaction Analysis

Accountants record business transactions using this fundamental accounting equation. When an accountant records a transaction that affects the business, he or she will record what effect the transaction has on the assets of the business and what effect it has on the financing of the business. This process is called transaction analysis.

Stockholders' Equity

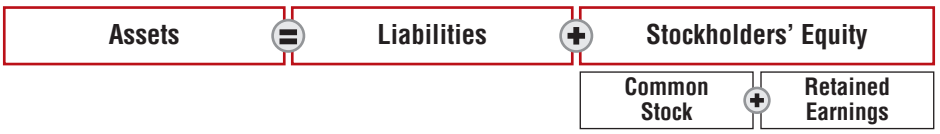
Before we start learning how transactions affect the accounting equation, let's take a closer look at the stockholders' equity section of the equation. Stockholders' equity, sometimes called shareholders' equity, is the phrase used to describe owners' equity in a corporation. To provide more useful information to various people, the stockholders' equity section of the equation can be broken down into smaller subcategories:

Common stock The stockholders' equity that is the result of the owners of the business investing money (or other assets) into the business.

Retained earnings The stockholders' equity that is the result of the business having net income, or net earnings, that have been retained in the business.

- **Common stock** is used to reflect stockholders' equity that is the result of the owners of the business investing money (or other assets) into the business.
- **Retained earnings** is used to reflect stockholders' equity that is the result of the business having net income, or net earnings, that have been retained in the business. As we saw earlier (on page 5), net income is created when the business has revenue that exceeds expenses. A net loss occurs when a business has expenses that exceed revenue.

An expanded version of the accounting equation would look like this:



(what the business owns) (who provides the money)

The retained earnings subcategory can now be broken down into further subcategories to help the accountant provide even better information. These are the subcategories and the information they reflect:

- *Revenues* are used to reflect an increase in retained earnings that is the result of the business providing goods and services.
- *Expenses* are used to reflect a decrease in retained earnings that is the result of the business incurring costs related to providing goods and services.

- *Dividends* are used to reflect a decrease in retained earnings that is the result of the owners receiving assets (usually cash) from the business.

An expanded version of the accounting equation would now look like this:

Assets	=	Liabilities	+	Stockholders' Equity	
				Common Stock	+ Retained Earnings

Common Stock	+ Revenues	− Expenses	− Dividends

Retained Earnings and, therefore, Stockholders' Equity increases by adding amounts to Revenues. Retained Earnings and, therefore, Stockholders' Equity decrease by adding amounts to expenses and dividends. These subcategories will make more sense as we learn how they are used to record the effects of business transactions. To illustrate, let's assume Brian Miller, one of the owners of Bold City Brewery, wanted to help the industry grow, so he decided to start a consulting business and offer consulting services to start-up breweries. Now, let's analyze the effects of several transactions on the accounting equation for the month of January 2018 for Bold City Consulting, Inc., the new consulting business started by Brian.

1. *Sale of stock.* Brian Miller invests $10,000 to start the business. Bold City Consulting, Inc., sells Brian $10,000 of common stock in exchange for his cash investment. The effect of this transaction on the accounting equation is to increase Assets and increase Stockholders' Equity:

Assets	=	Liabilities	+	Stockholders' Equity	
				Common Stock	+ Retained Earnings

	Cash	=	Common Stock	+ Revenues	− Expenses	− Dividends
(1)	**+$10,000**		**+$10,000**			
Bal	$10,000	=	$10,000			

Remember that, for each transaction, the amount on the left side of the equation must equal the amount on the right side. The amount of assets will be increased by $10,000 because the business now has $10,000 of cash that it did not have before. To keep track of what type of assets the business has, the accountant will create a subcategory under assets for each different type of asset that the business has, so a subcategory for Cash was created. Because the assets have increased, there is now a need to increase the ownership side of the equation. The business does not owe the $10,000 to a third party, so the $10,000 ownership interest must belong to Brian and must be entered in the Stockholders' Equity section of the equation. If we look there, we can see two possible places where the $10,000 can be entered in order to increase Stockholders' Equity: Common Stock and Retained Earnings. Based on the definitions of when each of these would be used, as discussed previously, we see that the $10,000 should be entered in the Common Stock section of Stockholders' Equity because this increase in Stockholders' Equity was the result of Brian investing assets into the business.

2. *Purchase supplies on credit.* Bold City Consulting purchases office supplies, agreeing to pay $250 within 30 days. The effect of this transaction on the accounting equation is to increase Assets and increase Liabilities:

	Assets			=	Liabilities	+	Stockholders' Equity			
							Common Stock	+	Retained Earnings	
	Cash	+	Supplies	=	Accounts Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$10,000			=			$10,000			
(2)			**+$250**		**+$250**					
Bal	$10,000	+	$250	=	$250	+	$10,000			

Prepaid expenses Amounts that are assets of a business because they represent items that have been purchased but will be used later.

Accounts payable A liability incurred by a business when purchasing goods and services.

The Supplies account is an asset because the supplies purchased have not been used yet. Supplies are an example of what we call **prepaid expenses**, which are considered to be assets until they have been used up in business operations. The agreement to pay for them later creates an **accounts payable**, a liability, because the business owes $250 to a third party.

3. *Purchase equipment for cash.* The business purchases equipment (a computer and a printer), paying $1,400 cash. The effect of this transaction on the accounting equation is to increase one asset and decrease another asset:

	Assets					=	Liabilities	+	Stockholders' Equity			
									Common Stock	+	Retained Earnings	
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$10,000	+	$250			=	$250	+	$10,000			
(3)	**−$1,400**				**+$1,400**							
Bal	$8,600	+	$250	+	$1,400	=	$250	+	$10,000			

The cash purchase of equipment increases one asset, Equipment, and decreases another asset, Cash, by the same amount. After the transaction is completed, Bold City Consulting has total assets of $10,250, liabilities of $250, and stockholders' equity of $10,000. This type of transaction is referred to as a *shift in assets*. Because the total amount of assets has not changed, ownership should not change; therefore, the amount of Liabilities and Stockholders' Equity will not change.

4. *Borrow cash from the bank.* Bold City Consulting borrows $2,500 cash from the bank and signs a two-year note payable to the bank. The effect of this transaction on the accounting equation is to increase Assets and increase Liabilities:

	Assets					=	Liabilities			+	Stockholders' Equity			
											Common Stock	+	Retained Earnings	
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Notes Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$8,600	+	$250	+	$1,400	=	$250			+	$10,000			
(4)	**+$2,500**							+	**$2,500**					
Bal	$11,100	+	$250	+	$1,400	=	$250	+	$2,500	+	$10,000			

Note payable A liability represented by a written promise that requires future payment.

A **note payable** is a written promise to pay a specified amount in the future. Businesses often borrow money from a bank in order to purchase assets or to make sure enough cash is available to operate the business. Borrowing cash from a bank increases the asset Cash because the business has $2,500 that it did not have before. It also increases the liability Notes Payable by $2,500 because the business owes $2,500 to the bank. In other words, the bank has an ownership interest in $2,500 of Bold City Consulting's assets. Note that total assets of $12,750 still equal the total liabilities of $2,750 plus the stockholders' equity of $10,000.

5. *Provide services for cash.* Bold City Consulting earns service revenue by providing consulting services for clients. Bold City collects $2,600 cash for services provided. The effect of this transaction on the accounting equation is to increase Assets and increase Stockholders' Equity as follows:

Assets						Liabilities			Stockholders' Equity				
									Common Stock		Retained Earnings		
	Cash	+ Supplies	+	Equipment	=	Accounts Payable	+ Notes Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$11,100	+ $250	+	$1,400	=	$250	+ $2,500	+	$10,000			
(5)	**+$2,600**									**+$2,600**		
Bal	$13,700	+ $250	+	$1,400	=	$250	+ $2,500	+	$10,000	+ $2,600		

Providing services increases both Cash and Revenues by $2,600. Cash is increased because the business has $2,600 that it did not have before, and Revenues is increased because Stockholders' Equity must be increased to reflect that Brian, the sole stockholder, has an ownership interest in the increased assets. As previously discussed, the specific subcategory used to increase Retained Earnings (and, therefore, Stockholders' Equity) due to providing goods and services is Revenues.

On account Buying or selling on credit.

Accounts receivable An asset that represents amounts owed to the business by customers.

6. *Provide services on credit.* A business can also earn service revenue even if it has not yet received cash for these services. Bold City Consulting performs $3,150 of services and, in return, receives customers' promises to pay this $3,150 within one month. In accounting, we say that Bold City Consulting performed this service **on account**. A client's promise to pay is called an **account receivable**. It is an asset because the business has the right to collect the cash in the future. The effect on the accounting equation is to increase Assets and increase Stockholders' Equity:

Assets						Liabilities			Stockholders' Equity				
									Common Stock		Retained Earnings		
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	=	Accounts Payable	+ Notes Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$13,700		+ $250	+ $1,400	=	$250	+ $2,500	+	$10,000	+ $2,600		
(6)		**+$3,150**								**+$3,150**		
Bal	$13,700	+ $3,150	+ $250	+ $1,400	=	$250	+ $2,500	+	$10,000	+ $5,750		

Notice that the Revenues account was increased just as it was in the previous transaction when Bold City Consulting performed services and received cash. The Revenues account was increased to reflect that the stockholders' ownership interest in the assets of the business has increased. In transaction 5, the assets increased because the business received cash; in transaction 6, the assets increased because the business received an account receivable.

7. *Partial payment of accounts payable.* Bold City Consulting pays $150 to the store where it purchased $250 worth of supplies in transaction 2. In accounting, this

is referred to as "paying on account." The effect on the accounting equation is to decrease Assets and decrease Liabilities:

	Assets							=	Liabilities			Stockholders' Equity					
												Common Stock		Retained Earnings			
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Notes Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$13,700	+	$3,150	+	$250	+	$1,400	=	$250	+	$2,500	+	$10,000	+ $5,750		
(7)	**−$150**								**−$150**							
Bal	$13,550	+	$3,150	+	$250	+	$1,400	=	$100	+	$2,500	+	$10,000	+ $5,750		

The payment of cash on account has no effect on Supplies because the payment does not affect the amount of supplies the business has. Likewise, the payment on account does not affect Expenses because the business is paying off an amount owed, not using those supplies. The Cash account decreases because the business has less cash and the Accounts Payable account decreases because the business owes less to a third party.

8. *Payment of expenses.* During the month, Bold City Consulting paid $2,300 cash for expenses incurred, such as wages, building rent, and utilities. Later, we will see that each different type of expense will be shown separately in the accounting equation, but for now we will lump them all together under the heading "Expenses." The effect on the accounting equation is to decrease Assets and decrease Stockholders' Equity:

	Assets							=	Liabilities			Stockholders' Equity					
												Common Stock		Retained Earnings			
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Notes Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$13,550	+	$3,150	+	$250	+	$1,400	=	$100	+	$2,500	+	$10,000	+ $5,750		
(8)	**−$2,300**														**+$2,300**	
Bal	$11,250	+	$3,150	+	$250	+	$1,400	=	$100	+	$2,500	+	$10,000	+ $5,750	− $2,300	

For this transaction, Cash decreases and Expenses increase. Because Expenses are subtracted from Retained Earnings, Retained Earnings (and, therefore, Stockholders' Equity) will decrease. This decrease in Stockholders' Equity reflects that the assets for the business have decreased and, therefore, less ownership interest has to be reported. Remember that Expenses are used to decrease Retained Earnings when needed as the result of the business incurring costs related to providing goods and services.

9. *Cash dividends.* Bold City Consulting pays $1,500 of cash dividends to Brian Miller, the stockholder. The effect on the accounting equation is to decrease Assets and decrease Stockholders' Equity as follows:

	Assets							=	Liabilities			Stockholders' Equity					
												Common Stock		Retained Earnings			
	Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Notes Payable	+	Common Stock	+ Revenues	− Expenses	− Dividends
Bal	$11,250	+	$3,150	+	$250	+	$1,400	=	$100	+	$2,500	+	$10,000	+ $5,750	− $2,300	
(9)	**−$1,500**															**+$1,500**
Bal	$9,750	+	$3,150	+	$250	+	$1,400	=	$100	+	$2,500	+	$10,000	+ $5,750	− $2,300	− $1,500

The payment of dividends causes a $1,500 decrease in Cash and a $1,500 increase in Dividends. Because Dividends are subtracted from Retained Earnings, Retained Earnings (and, therefore, Stockholders' Equity) will decrease. This decrease in Stockholders' Equity reflects that the assets for the business have decreased and, therefore, less ownership interest has to be reported. Dividends are different from expenses because the cash is paid directly to the owners rather than being paid for costs related to providing goods or services. Once again, we can see that the total assets of $14,550 still equal the total liabilities of $2,600 plus stockholders' equity of $11,950, so the accounting equation continues to balance. Remember that total Stockholders' Equity equals the Common Stock of $10,000 plus the Retained Earnings of $1,950. Retained Earnings was arrived at by calculating net earnings of $3,450 (subtracting the Expenses from the Revenues) and then subtracting the Dividends of $1,500.

Try It!

At the end of its first year of operations, Advantage Advertising, Inc., has assets totaling $162,000 and stockholders' equity totaling $114,000. What is the amount of Advantage Advertising's total liabilities at the end of the year?

Answer

We can use the fundamental accounting equation to figure out Advantage Advertising's total liabilities. First, it helps to restate the equation in a different format by subtracting stockholders' equity from both sides of the equation as follows:

Assets	−	Stockholders' Equity	=	Liabilities

Next, insert the amount of Advantage Advertising's total assets and the total stockholders' equity into the restated formula.

$162,000 – $114,000 = Liabilities

Finally, solve the equation to get the total liabilities of $48,000.

$162,000 – $114,000 = $48,000

How Do You Report Business Transactions Using Financial Statements?

6 Understand and be able to prepare basic financial statements

Financial statements Historical, objective reports, prepared according to GAAP, that communicate financial information about a business.

Accounting is the process of recognizing, measuring, recording, and reporting information about a business's economic transactions. But what process of reporting do accountants use?

To report the results of a business's transactions for a period, **financial statements** need to be prepared. These reports show the entity's financial information to interested stakeholders both inside and outside the organization. Four basic financial statements are prepared by most organizations:

- Income statement
- Statement of retained earnings
- Balance sheet
- Statement of cash flows

The Income Statement

Income statement A financial statement that reports the revenue and expenses of a business during a given period of time.

An **income statement** answers the question, "Is the organization generating any net income?" Just as a scoreboard shows how many points a team earned for a specific period of time, a business prepares an income statement to show, for a specific time period, the revenue earned and the expenses incurred to produce that revenue. Like the scoreboard that shows whether a team is winning or losing, the income statement shows whether a business generated *net income* (total revenue was greater than total expenses, where total expenses are total operating expenses plus interest expense) or a *net loss* (total revenue is less than total expenses). To prepare an income statement, we set up a format that includes a heading and the body of the statement. The heading of all financial statements should show "who," "what," and "when." The "who" is the name of the business, the "what" is the name of the financial statement, and the "when" is the time period covered by the statement. The body of the income statement lists the revenue, then the expenses, and finally the net income or net loss. When revenue is greater than expenses, the business earns net income, or profit. When expenses are greater than revenue, the business has a net loss. We can prepare an income statement for Bold City Consulting for the month of January 2018 by referring to the ending balances in the accounting equation we recently completed.

If we look at **Exhibit 1-2**, we can see what the income statement for Bold City Consulting looks like. In the first month of operations, Bold City Consulting, Inc., earned $5,750 in revenue and had $2,300 in expenses that resulted in net income of $3,450. This amount can remain part of the stockholders' equity in the business and can be used to "grow" or expand the business, or the business can distribute dividends to the stockholders.

Notice the dollar signs on the first and last amounts and the double underline under the last amount presented on the statement (Net Income). It is common practice to place a dollar sign on the first number and the last number in each column on a financial statement and to double underline the final amount.

The Statement of Retained Earnings

Statement of retained earnings A financial statement that reports the amount of accumulated net profits a business has retained and not paid in dividends since inception. The statement reports the beginning balance of retained earnings, plus net income or minus net loss in the given period, less the dividends during the given period, equaling ending retained earnings.

"How much net income has the corporation made and kept during the current accounting period?" The **statement of retained earnings** answers this question by presenting the amount of the retained earnings and the changes to it during a specific time period, such as a month or a year. Increases in retained earnings come from net income and decreases result from either a net loss or the payment of dividends.

To prepare the statement of retained earnings, we set up a format that includes a heading and body similar to the income statement. The heading includes the name of the business, the name of the financial statement, and the time period covered by the statement. The body of the statement lists the beginning retained earnings balance, any net income earned or net loss incurred, any dividends paid, and the ending balance of Retained Earnings. Using the information from the income statement we just prepared and the dividend information from our accounting equation, we can prepare a statement of retained earnings.

Exhibit 1-2 shows what Bold City Consulting's statement of retained earnings looks like. Because this is the first month that Bold City Consulting has been in business, there is a zero balance in beginning Retained Earnings. During the first month of operations, Bold City Consulting, Inc., paid dividends of $1,500, which, when combined with the $3,450 of net income for January, leaves an ending Retained Earnings balance at January 31 of $1,950. Of the $3,450 that Bold City Consulting earned during January, we can see that $1,950 was retained in the business.

The Balance Sheet

Balance sheet or statement of financial position A financial statement that reports the assets, liabilities, and stockholders' equity of a business at a specific point in time.

"What assets does the company have, and who has ownership rights to those assets?" The **balance sheet** answers this question by listing all of an entity's assets, liabilities, and stockholders' equity as of a specific date, usually the end of a month or a year. Basically, the balance sheet shows the accounting equation for a business and reflects the fact that assets equal liabilities plus stockholders' equity. The balance sheet is also known as the **statement of financial position**. Using the information from the statement of

Exhibit 1-2

Bold City Consulting, Inc.
Income Statement
Month Ended January 31, 2018

Revenue	$5,750
Expenses	2,300
Net Income	$3,450

Bold City Consulting, Inc.
Statement of Retained Earnings
Month Ended January 31, 2018

Retained Earnings, January 1, 2018	$ 0
Add: Net Income for the month	3,450
Subtotal	3,450
Less: Dividends	1,500
Retained Earnings, January 31, 2018	$ 1,950

Bold City Consulting, Inc.
Balance Sheet
January 31, 2018

ASSETS		**LIABILITIES**	
Cash	$9,750	Accounts Payable	$ 100
Accounts Receivable	3,150	Notes Payable	2,500
Supplies	250	Total Liabilities	2,600
Equipment	1,400		
		STOCKHOLDERS' EQUITY	
		Common Stock	10,000
		Retained Earnings	1,950
		Total Stockholders' Equity	11,950
Total Assets	$14,550	Total Liabilities & Stockholders' Equity	$14,550

Bold City Consulting, Inc.
Statement of Cash Flows
Month Ended January 31, 2018

Cash flows from operating activities:		
Net income		$3,450
Adjustments to reconcile net income to net cash used in operating activities:		
Increase in current assets	$(3,400)	
Increase in current liabilities	100	(3,300)
Net cash provided by operating activites		150
Cash flows from investing activities:		
Purchase of equipment	(1,400)	
Net cash used in investing activities		(1,400)
Cash flows from financing activities:		
Proceeds from issuance of commmon stock	10,000	
Proceeds from issuance of notes payable	2,500	
Payment of dividends	(1,500)	
Net cash provided by financing activities		11,000
Net increase in cash		9,750
Cash balance January 1, 2018		0
Cash balance January 31, 2018		$9,750

retained earnings we just prepared and the ending balances from our accounting equation, we can prepare a balance sheet for Bold City Consulting. Exhibit 1-2 shows what Bold City Consulting's balance sheet looks like. Notice that total assets equal total liabilities and stockholders' equity.

The Statement of Cash Flows

Statement of cash flows A financial statement that reports the sources and uses of cash for a given period of time.

Operating activities Activities that create revenue and/or expenses for the entity.

Investing activities Decisions made by management to buy and sell long-term assets.

Financing activities Actions that generate the receipt of cash from raising capital or the payment of long-term liabilities.

"Where did the business get the money it needed to operate, and where did it spend its money?" The **statement of cash flows** answers this question by showing stakeholders all of the sources and all of the uses of cash by a business for a specified period of time. On the statement of cash flows, the sources and uses of cash are reported for three different types of business activities:

1. **Operating activities** are activities that *generate revenue and/or expenses*, such as providing goods or services.
2. **Investing activities** are the decisions made by management *to buy and sell long-term assets*, such as buying equipment.
3. **Financing activities** are those actions that generate the receipt of cash from raising capital, such as selling common stock or borrowing money. Also includes the payment of cash to pay long-term liabilities and dividends.

Exhibit 1-2 shows what Bold City Consulting's statement of cash flows looks like. Notice that the cash balance reported on the balance sheet equals the ending cash balance reported on the statement of cash flows. The statement of cash flows will be covered in more detail in Chapter 11.

Relationships Among the Financial Statements

The financial statements are prepared in the following order:

1. Income statement
2. Statement of retained earnings
3. Balance sheet
4. Statement of cash flows

The reason for this order is that the net income figure from the income statement is needed to prepare the statement of retained earnings. Likewise, the ending retained earnings balance from the statement of retained earnings is needed to prepare the balance sheet. Finally, information from both the income statement and the balance sheet is needed to prepare the statement of cash flows.

Focus on Decision Making

"What Is the Business?"

Think of a business. It may be a big business such as Kroger or Facebook, or a small business such as your local doctor. Now think about the following questions:

1. Why does the business exist?
2. What type of business is it?
3. What does the business sell?
4. What expenses does the business incur as it operates?

5. What assets and people are needed to operate the business?
6. Where could the business get the money to finance the assets and pay the employees?

Businesses all exist to create value for their stakeholders, especially their owners. But each business tries to be different. Businesses compete. To be successful, they need to be special.

The Income Statement

The income statement of the business tells the owners and managers the revenues (or sales) and expenses a business has experienced during a period of time. Different businesses have different types of revenues and expenses. The revenues and expenses incurred by your doctor are different from the revenues and expenses incurred by Kroger or Facebook.

The Balance Sheet

Different businesses need different types of assets to be successful. Your doctor sells his or her services, whereas Walmart sells clothing, tools, and other household products. Your doctor's office is small compared with the big buildings used by Kroger and Facebook. The balance sheet of a business reflects the different assets a business needs to operate. Given that businesses are different, it is reasonable to expect that they use dissimilar ways to finance their assets. They may have different amounts and types of liabilities and owners' equity.

How They Do It: A Look at Business

Think about how different businesses operate. First, think about a microbrewery such as the Bold City Brewery.[4] A microbrewery makes and sells beer. In selling beer, the microbrewery incurs expenses such as the cost of the ingredients of the beer and employee salaries. It needs assets such as cash, beer (called inventory), equipment, and buildings. A microbrewery needs to finance these assets with liabilities and stockholders' equity.

So let's imagine we own and operate a microbrewery like the Millers' Bold City Brewery. We produce and sell $3,000,000 in beer. In producing and selling the beer, we incur expenses. Let's assume our cost of goods (beer) sold and other expenses totaled $2,700,000. That leaves us net income of $300,000. But to make and sell beer, we need assets. Let's assume we'd need $1,500,000 in assets. But to purchase assets, we need financing. Let's assume we financed our assets with $750,000 in liabilities and $750,000 in stockholders' equity.

In summary, to make $300,000 in net income, we sold $3,000,000 in beer and incurred $2,700,000 in expenses. To produce and sell the beer, we had $1,500,000 in assets financed with $750,000 in liabilities and $750,000 in stockholders' equity.

Let's look at another example: the grocery store Kroger. Kroger buys and sells food. It needs assets such as cash, food (called inventory), equipment, and buildings. Kroger finances these assets with liabilities and stockholders' equity. For the year ended January 28, 2017, Kroger reported sales of $115,337 million, expenses of $113,362 million, and net income of $1,975 million. At January 28, 2017, Kroger reported assets of $36,505 million, financed with $29,795 million in liabilities and $6,710 million in stockholders' equity. In summary, to make $1,975 million in net income, Kroger sold food for $115,337 million and incurred expenses of $113,362 million. To sell the food, Kroger had $36,505 million in assets financed with $29,795 million in liabilities and $6,710 million in stockholders' equity.

Last, let's consider Facebook, the social media company. Facebook sells advertising and other Internet services. To do so, it incurs expenses. It needs cash, computers,

[4]The numbers used to demonstrate how a microbrewery operates are representative of the microbrewing industry. However, the numbers used do not reflect the actual operations of the Bold City Brewery.

and software. For the year ended December 31, 2016, Facebook reported revenues of $27,638 million, expenses of $17,421 million, and net income of $10,217 million. At December 31, 2016, Facebook reported assets of $64,961 million, financed with $5,767 million in liabilities and $59,194 million in stockholders' equity. In summary, to make $10,217 million in net income, Facebook sold services for $27,638 million and incurred expenses of $17,421 million. To sell the services, Facebook had $64,961 million in assets financed with $5,767 million in liabilities and $59,194 million in stockholders' equity. So how do real businesses operate? Real businesses all have sales and expenses, resulting in either net income or loss. Real businesses have assets financed with liabilities and stockholders' equity. Although different businesses operate differently, all businesses have sales, expenses, assets, liabilities, and stockholders' equity. A business's stakeholders want to make good decisions that create value. But to do so, its stakeholders need good information that informs them of the business's sales, expenses, assets, liabilities, and/or stockholders' equity. That's the responsibility of accountants. Accountants recognize, measure, record, and report a business's transactions. To do this, accountants use rules and methods (GAAP) to create balance sheets (assets = liabilities + stockholders' equity) and income statements (sales − expenses). It's how real businesses do it.

Decision Guidelines

Decision	Guideline	Analyze
How do I understand how a business operates?	The income statement reports revenues and expenses of a business. Revenues represent what a business earns as a result of providing goods or services. Expenses represent the cost to the business of providing those goods or services.	If revenues exceed expenses, the business is profitable and has earned net income. However, if expenses exceed revenue, the business has incurred a net loss and is not profitable.
	The statement of retained earnings shows whether the net income of a business was paid out as dividends or retained in the business.	If a business is planning to grow, it will often issue low or no dividends to shareholders. This way, it retains the income in the business.
	The balance sheet reflects the assets, liabilities, and stockholders' equity of the business.	The liabilities of a business reflect the claims of third parties to the assets of the business. Once those claims are settled, the remaining assets belong to the stockholders (the owners) of the business. This amount is reflected by the stockholders' equity on the balance sheet.
	The statement of cash flows reflects the sources and uses of cash over a period of time.	You can see whether a company's operations generated cash for the business and how much cash the business invested in the purchase of assets such as buildings and equipment. If a company's operations generated insufficient funds to finance its investments in assets, you can determine how the business financed these acquisitions.

Accounting, Business, and You—Putting It All Together

So what is accounting? Accounting is the process of recognizing, measuring, recording, and reporting information about a business's economic transactions. Accounting is the language of business.

What is a business? A business is an organization recognized under law that attempts to create value by exchanging products with customers for money. Why does a business exist? A business exists to create value. How does a business create value? A business acquires money (liabilities and owners' equity) and uses money to hire people and acquire assets. The people (employees) then use the assets to generate revenue and expenses that they hope will result in enough net income to compensate the owners for the use of their money.

It's not easy to create value. Managing a business is both challenging and rewarding. It's a challenge to blend all the parts of a business into a cohesive organization that delivers value for all stakeholders, particularly owners. A business is a team comprising people, assets, liabilities, and owners' equity. To compete successfully, a business must combine and manage all the parts or players in the business just right.

To be successful, a business needs good information. That's the job of accounting. Accountants are the scorekeepers of business. Like all good scorekeepers, they have rules. The rules accountants use are called Generally Accepted Accounting Principles (GAAP). Accountants use GAAP to create financial statements. The four primary statements are the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows.

So look around. What do you see? You see businesses. You see people and organizations creating, producing, and selling products. And in doing so, you see businesses creating value. However, a very important part of that value-creating process is keeping track of your revenues, expenses, assets, liabilities, and owners' equity. In other words, as a business owner or manager, accounting is important to you.

Summary

MyLab Accounting

Here is what you should know after reading this chapter. MyLab Accounting will help you identify what you know and where to go when you need practice.

	Key Points	Key Accounting Terms
1 Understand the nature of business and the role of accounting in business	A business is a legal organization that attempts to create value by exchanging products with customers for money. Accounting is the process of recognizing, measuring, recording, and reporting business transactions.	**Accounting** (p. 2) **Business** (p. 2) **Cost** (p. 3) **Customer** (p. 3) **Goods** (p. 2) **Loss** (p. 4) **Product** (p. 2) **Profit** (p. 3) **Revenue** (p. 3) **Risk** (p. 4) **Sale** (p. 3) **Services** (p. 2) **Stakeholder** (p. 4) **Value** (p. 3)

	Key Points	Key Accounting Terms
2 Know how a business operates	A business obtains money from owners and lenders. Owners and lenders expect a return that compensates them for time and risk. Owners expect a profit, the difference between revenue and costs. Lenders expect interest. A business uses the money provided by owners and lenders to hire employees and invest in assets. Employees then use the assets to generate revenue and incur costs.	**Asset** (p. 5) **Employees** (p. 5) **Expense** (p. 5) **Interest** (p. 5) **Liabilities** (p. 5) **Net income** (p. 5) **Owners' equity** (p. 5) **Stockholders' equity** (p. 5)
3 Describe the different types and forms of businesses	There are many types of businesses. A business is organized under the law as a sole proprietorship, a partnership, a corporation, or a limited liability company.	**Corporation** (p. 7) **Dividend** (p. 7) **For-profit business** (p. 6) **Limited liability company** (p. 7) **Manufacturing business** (p. 6) **Merchandise business** (p. 6) **Not-for-profit business** (p. 6) **Partnership** (p. 7) **Retail business** (p. 7) **S-corporation** (p. 7) **Service business** (p. 6) **Sole proprietorship** (p. 7) **Stockholder** (p. 7) **Wholesale business** (p. 7)
4 Identify the key accounting principles and concepts	Accounting is governed by rules, called Generally Accepted Accounting Principles (GAAP).	**Actual cost** (p. 10) **Business entity principle** (p. 10) **Cost principle** (p. 10) **Financial accounting** (p. 9) **Financial Accounting Standards Board (FASB)** (p. 9) **Generally Accepted Accounting Principles (GAAP)** (p. 9) **Historical cost** (p. 10) **International Financial Reporting Standards (IFRS)** (p. 9) **Objectivity principle** (p. 10) **Reliability principle** (p. 10)

	Key Points	Key Accounting Terms
5 Explain how accounting functions in a business	Accounting is a critical part of a successful business. Accounting is the scorekeeping function of what the business is doing. It must recognize, measure, record, and report the resources a business owns. These resources are called assets. Accounting must also account for the sources of the money to acquire the assets, money provided by owners or lenders. Last, accounting must account for how the business operates and whether it generates a profit, where revenue exceeds expenses, or a loss, where revenue is less than expenses.	**Accounts payable** (p. 15) **Accounts receivable** (p. 16) **Accrual accounting** (p. 12) **Cash accounting** (p. 11) **Common stock** (p. 13) **Fundamental accounting equation** (p. 13) **Note payable** (p. 16) **On account** (p. 16) **Prepaid expenses** (p. 15) **Retained earnings** (p. 13)
6 Understand and be able to prepare basic financial statements	Accounting uses the accounting equation to produce four financial statements: the income statement, the balance sheet, the statement of retained earnings, and the statement of cash flows.	**Balance sheet** (p. 19) **Financial statements** (p. 18) **Financing activities** (p. 21) **Income statement** (p. 19) **Investing activities** (p. 21) **Operating activities** (p. 21) **Statement of cash flows** (p. 21) **Statement of financial position** (p. 19) **Statement of retained earnings** (p. 19)

Accounting Practice

Discussion Questions

1. The text states that accounting is the "language of business." What does this mean? Why is it important to know the language?
2. Would you describe accounting as primarily a technical discipline or primarily an ethical discipline? Why?
3. Financial statements are defined as "historical reports that communicate financial information about a business to people or organizations outside the company." Why is the word *historical* used?
4. What are some reasons why accounting has adopted "historical" financial statements as the model? What are some disadvantages associated with presenting "historical" financial statements?
5. What are some of the uses of financial statements?
6. What is the primary way in which corporations differ from proprietorships and partnerships? What are some of the factors that might affect a person's decision about the form of organization that would be best in a given situation?
7. What is the fundamental accounting equation? Define each of the components of this equation.
8. How is the accounting equation affected by each of these transactions?
   a. Owners contribute cash to start the business in exchange for common stock.
   b. The company borrows money from the bank.
   c. The company provides services for a client who promises to pay later.
   d. The company collects from the customer in transaction c.
9. In what order should the financial statements be prepared? Why?
10. Which financial statement would be most useful to answer each of the following questions?
    a. Does the corporation have enough resources to pay its short-term debts?
    b. What is the corporation's policy toward "growing the company" versus distributing its wealth to owners?
    c. Did the corporation pay its operating costs with resources generated from operations, money borrowed from banks, or money generated from selling off its buildings and equipment?
    d. Did the corporation make a profit last year?

MyLab Accounting

Go to **http://www.pearson.com/mylab/accounting** for the following Short Exercises, Exercises, and Problems. They are available with immediate grading, explanations of correct and incorrect answers, and interactive media that acts as your own online tutor.

Self Check

1. Which type of business organization is owned by its stockholders?
   - **a.** Proprietorship
   - **b.** Partnership
   - **c.** Corporation
   - **d.** All the above are owned by stockholders.

2. The majority of Generally Accepted Accounting Principles (GAAP) are created by the
   - **a.** Institute of Management Accountants (IMA).
   - **b.** Securities and Exchange Commission (SEC).
   - **c.** American Institute of Certified Public Accountants (AICPA).
   - **d.** Financial Accounting Standards Board (FASB).

3. Which accounting principle specifically states that we should record transactions at amounts that can be verified?
   - **a.** Business entity principle
   - **b.** Cost principle
   - **c.** Reliability principle
   - **d.** Going-concern principle

4. Wave Rider is famous for custom skateboards. At the end of a recent year, Wave Rider's total assets added up to $884,000 and stockholders' equity was $187,000. How much did Wave Rider owe creditors?
   - **a.** $1,071,000
   - **b.** $884,000
   - **c.** $697,000
   - **d.** $187,000

5. Assume that Wave Rider sold skateboards to a department store for $28,000 cash. How would this transaction affect Wave Rider's accounting equation?
   - **a.** Increase both assets and stockholders' equity by $28,000
   - **b.** Will not affect the accounting equation because the effects cancel out
   - **c.** Increase both assets and liabilities by $28,000
   - **d.** Increase both liabilities and stockholders' equity by $28,000

6. Assume that Wave Rider sold skateboards to another department store for $18,000 on account. Which parts of the accounting equation does a sale on account affect?
   - **a.** Accounts Payable and Cash
   - **b.** Accounts Receivable and Retained Earnings
   - **c.** Accounts Receivable and Accounts Payable
   - **d.** Accounts Payable and Retained Earnings

7. Assume that Wave Rider paid expenses totaling $32,000. How does this transaction affect Wave Rider's accounting equation?
   - **a.** Increases assets and decreases liabilities
   - **b.** Decreases both assets and stockholders' equity
   - **c.** Increases both assets and stockholders' equity
   - **d.** Decreases assets and increases liabilities

8. Consider the overall effects of the transactions in questions 5, 6, and 7 on Wave Rider. What is Wave Rider's net income or net loss?
   - **a.** Net loss of $4,000
   - **b.** Net income of $46,000
   - **c.** Net income of $14,000
   - **d.** It cannot be determined from the data given.

9. The balance sheet reports

a. a business's financial position on a specific date.
b. a business's results of operations on a specific date.
c. a business's results of operations for a specific period.
d. a business's financial position for a specific period.

10. The income statement reports

a. a business's financial position for a specific period.
b. a business's results of operations on a specific date.
c. a business's financial position on a specific date.
d. a business's results of operations for a specific period.

Watch the Real World Video "Real World Accounting: David Hitchner, ABC Wine" in MyLab Accounting to answer the following two questions.

11. According to the Real World Accounting Video, the objective of business is to create value. True or False?

12. According to the Real World Accounting Video, _____ are important reports business managers use in managing their business.

a. balance sheets
b. income statements
c. both balance sheets and income statements

Answers are given after Written Communication.

MyLab Accounting

Short Exercises

S1-1. Accounting principles (*Learning Objective 4*) 5–10 min.

Place the corresponding letter of the definition next to the term.

____ 1. Cost principle	a. An organization that stands as a separate economic unit must not have its financial affairs confused with that of other entities.
____ 2. Business entity principle	b. Data must be verifiable.
____ 3. Generally Accepted Accounting Principles	c. The standards developed by FASB.
____ 4. Reliability principle	d. Acquired assets and services should be recorded at their actual cost.

S1-2. Accounting principles (*Learning Objective 4*) 5–10 min.

Jack Sanders owns and operates Jack's Java Coffee Shop. He proposes to account for the shop's assets at their current market value in order to have current amounts on the balance sheet. Which accounting concept or principle does Jack violate?

a. Business entity principle
b. Going-concern principle
c. Reliability principle
d. Cost principle

S1-3. Accounting terminology (*Learning Objectives 2 & 3*) 10–15 min.

Place the corresponding letter of the definition next to the term.

____ 1. Liabilities	a. Any event that affects a firm's financial position
____ 2. Assets	b. Organization form with a single owner
____ 3. Corporation	c. Organization form with two or more owners
____ 4. Dividends	d. Organization form that can have an unlimited life
____ 5. Sole proprietorship	e. Debt owed to outsiders
____ 6. Partnership	f. Economic resources of the business
____ 7. Transaction	g. Payment of cash to the owners of a corporation

S1-4. Basic accounting equation (*Learning Objective 5*) 5–10 min.

Determine the missing amounts in the following accounting equations.

	Assets	=	Liabilities	+	Stockholders' Equity
a.	$106,000	=	$24,000	+	?
b.	?	=	$63,000	+	$28,000
c.	$94,000	=	?	+	$45,000

S1-5. Basic accounting equation (*Learning Objective 5*) 5–10 min.

Ellen Beach owns Ellen's Lawncare Service. The business has cash of $13,000 and equipment that costs $35,000. Debts of the business include accounts payable of $9,000 and a $5,000 note payable. Determine the amount of stockholders' equity Ellen has in the business. Write the accounting equation for Ellen's Lawncare Service.

S1-6. Basic accounting equation (*Learning Objective 5*) 5–10 min.

Boehms, Inc. has cash of $36,000, supplies costing $1,500, and stockholders' equity of $28,000. Determine the liabilities of the business. Write the accounting equation for Boehms, Inc.

S1-7. Basic accounting equation (*Learning Objective 5*) 5–10 min.

Qwick Care Clinic, Inc. started a business when Dr. Hamm purchased $15,000 of common stock in the business for cash. Before starting operations, Qwick Care Clinic, Inc. borrowed $18,000 cash by signing a note payable to 1st National Bank. Account for these two transactions in the accounting equation.

S1-8. Entering transactions in the accounting equation (*Learning Objective 5*) 5–10 min.

Sanchez Towing Service, Inc. earns service revenue by towing vehicles for AAA. Sanchez Towing Service's main expenses are the salaries paid to its employees. Account for the following transactions in the expanded accounting equation:

a. Sanchez Towing Service, Inc. earned $62,000 of service revenue on account.

b. Sanchez Towing Service, Inc. paid $33,000 in salaries expense.

S1-9. Basic accounting equation (*Learning Objective 5*) 5–10 min.

Match each of the following items with its location in the expanded accounting equation. Use the most detailed category appropriate.

____ 1. Utilities Expense
____ 2. Accounts Receivable
____ 3. Common Stock
____ 4. Office Supplies
____ 5. Lease Expense, Computer
____ 6. Salaries Expense
____ 7. Cash
____ 8. Rent Expense, Office
____ 9. Service Revenue
____ 10. Accounts Payable
____ 11. Land

a. Assets
b. Liabilities
c. Stockholders' Equity
d. Revenues
e. Expenses

S1-10. Basic financial statements (*Learning Objective 6*) 5–10 min.

Label each of the items listed with the abbreviation of the financial statement on which it appears. Items may appear on more than one statement.

Income Statement (IS)

Balance Sheet (BS)

Statement of Retained Earnings (RE)

____ 1. Accounts Receivable

____ 2. Notes Payable

____ 3. Advertising Expense

____ 4. Service Revenue

____ 5. Retained Earnings

____ 6. Office Supplies

S1-11. Entering transactions in the accounting equation (*Learning Objective 5*) 5–10 min.

As a manager of a department store, you must deal with a variety of business transactions. Place the letter of each of the following transactions next to the effect it has on the accounting equation.

a. Paid cash to the stockholders as a distribution of earnings

b. Paid cash to purchase land for building site

c. Paid cash on an account payable

d. Sold stock to stockholders

e. Received cash from the bank in exchange for a note payable

____ 1. Increase an asset and increase stockholders' equity.

____ 2. Increase an asset and increase a liability.

____ 3. Increase one asset and decrease another asset.

____ 4. Decrease an asset and decrease stockholders' equity.

____ 5. Decrease an asset and decrease a liability.

S1-12. Transaction analysis (*Learning Objective 5*) 5–10 min.

Action Powersports, Inc., a corporation, sells and services personal watercraft. The business experienced the following events. State whether each event (a) increased, (b) decreased, or (c) had no effect on the total assets of the business, and identify the asset(s) involved in each transaction.

1. Sold additional stock to stockholders

2. Paid cash to purchase land as a building site

3. Paid cash on accounts payable

4. Purchased machinery and equipment; signed a 2-year note payable

5. Performed service for a customer on account

6. Paid cash to the stockholders as a distribution of earnings

7. Received cash from a customer on account

8. Sold land for a price equal to the cost of the land; received cash

9. Borrowed money from the bank

S1-13. Transaction analysis (*Learning Objective 5*) 5–10 min.

Presented here are nine transactions and the analysis used to account for them. Evaluate each of the suggested accounting treatments, and indicate whether it is true or false.

1. Received cash of $41,000 from the stockholders, who bought stock in the business
   Answer: Increase asset, increase stockholders' equity. _____ True _____ False
2. Paid $600 cash to purchase supplies
   Answer: Increase asset, increase stockholders' equity. _____ True _____ False
3. Earned service revenue on account, $1,200
   Answer: Increase asset, increase retained earnings. _____ True _____ False
4. Purchased office furniture on account at a cost of $450
   Answer: Increase asset, increase liability. _____ True _____ False
5. Received cash on account, $1,500
   Answer: Increase asset, decrease asset. _____ True _____ False
6. Paid cash on account, $175
   Answer: Increase asset, increase liability. _____ True _____ False
7. Sold land for $68,000 cash, which was the cost of the land.
   Answer: Increase asset, decrease asset. _____ True _____ False
8. Performed services and received cash of $825
   Answer: Increase asset, increase revenue. _____ True _____ False
9. Paid monthly office rent of $1,500
   Answer: Decrease asset, increase stockholders' equity. _____ True _____ False

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S1-14. Transaction analysis and calculating net income (*Learning Objective 5*) 5–10 min.

The analysis of Cunnington, Inc.'s first eight transactions follows. The business only sold stock once and paid no dividends.

	Assets				Liabilities		Stockholders' Equity	
	Cash	+ Accounts Receivable	+ Equipment	=	Accounts Payable	+ Notes Payable	+ Common Stock	+ Retained Earnings
1.	+ $40,000			=			+ $40,000	
2.	− 6,000		+ $ 6,000	=				
3.			+ 15,000	=		+ $15,000		
4.		+ $1,200		=				+ 1,200
5.	− 1,350			=				− 1,350
6.	+ 1,750			=				+ 1,750
7.	+ 350	− 350		=				
8.				=	+ 235			− 235

1. Label each of the transactions in the preceding analysis with the corresponding letter of the description that best fits it.
   a. Earned revenue for services provided, but customer will pay later
   b. Received cash from customers for services completed earlier in the month
   c. Received cash for revenue earned by providing services
   d. Paid cash for expenses incurred to operate the business
   e. Paid cash to purchase equipment
   f. Received utility bill in the mail. Bill will be paid in 30 days
   g. Sold stock to start the business
   h. Purchased equipment with a bank loan
2. If these transactions fully describe the operations of Cunnington, Inc., during the month, what was the amount of its net income or net loss?

MyLab Accounting

Exercises (Group A)

E1-15A. Basic accounting equation (*Learning Objective 5*) 10–15 min.

Determine the missing amounts in the following accounting equations.

	Assets	=	Liabilities	+	Stockholders' Equity
Hanson Corp.	?	=	$44,900	+	$10,300
Tiny Tots Daycare Inc.	$ 97,000	=	?	+	$39,000
Intermountain Inc.	$107,400	=	$91,500	+	?

Quick solution:

$16,000 increase

E1-16A. Basic accounting equation (*Learning Objective 5*) 10–15 min.

Bergmann's Deli had $142,000 of total assets and $87,000 of total stockholders' equity at December 31, 2018. At December 31, 2019, Bergmann's Deli had assets totaling $163,000 and stockholders' equity totaling $92,000.
After analyzing the data, answer the following questions:

1. What was the amount of the increase or decrease in liabilities during 2019?
2. Identify a possible reason for the change in liabilities during the year.

E1-17A. Basic accounting equation (*Learning Objective 5*) 10–15 min.

Tim's Tee Shirts started business in 2018 with total assets of $40,000 and total liabilities of $26,000. At the end of 2018, Tim's Tee Shirts total assets were $53,000 and total liabilities were $16,000.
After analyzing the data, answer the following questions:

1. What was the amount of the increase or decrease in stockholders' equity?
2. Identify two possible reasons for the change in stockholders' equity during the year.

E1-18A. Using the accounting equation to determine net income (*Learning Objectives 5 & 6*) 15–20 min.

The balance sheet data for Angel's Countertops, Inc., at August 31, 2018, and September 30, 2018, follow:

	Aug 31, 2018	Sep 30, 2018
Total Assets	$105,000	$180,000
Total Liabilities	75,000	129,000
Common Stock	10,000	10,000
Total Stockholders' Equity	?	?

Requirement

1. The following are three *independent* assumptions about the business during September. For each assumption, compute the amount of net income or net loss during September 2018. Find the solution by preparing the statement of retained earnings. First, use the amounts of total assets, total liabilities, and common stock given previously and the accounting equation to determine the beginning and ending retained earnings amounts. Then, plug those and the other amount given in each assumption into the statement of retained earnings to determine the net income or net loss.
   a. The business paid no dividends.
   b. The business paid $10,000 of dividends.
   c. The business paid $16,000 of dividends.

E1-19A. Transaction analysis (*Learning Objective 5*) 15–20 min.

Shavon Loreal opened a medical practice titled Shavon Loreal M.D., Inc. During August, the first month of operations, the business experienced the following events:

Aug	2	Loreal bought $60,000 of common stock in the business by opening a bank account in the name of Shavon Loreal M.D., Inc.
	6	The business paid $45,000 cash for land with the intention of building an office building on the land.
	11	The business purchased medical supplies for $700 on account.
	15	The business officially opened for business.
	17	The business treated patients and earned service revenue of $10,000, receiving cash.
	19	The business paid office rent, $1,400.
	22	The business sold supplies to another doctor for $300 cash, the cost of those supplies.
	25	The business received a $175 utility bill in the mail. The bill will be paid in 30 days.
	30	The business paid $100 on account related to the August 11 purchase.

Requirement

1. Analyze the effects of these events on the accounting equation of the medical practice of Shavon Loreal M.D., Inc. Use headings for Cash, Medical Supplies, Land, Accounts Payable, Common Stock, Service Revenue, Rent Expense, and Utility Expense.

E1-20A. Types of business organizations and balance sheet preparation (*Learning Objectives 3 & 6*) 10–15 min.

The following are the balances of the assets, liabilities, and equity of Fitness Fanatics at March 31, 2018:

Cash	$15,000	Office Equipment	$10,300
Retained Earnings	12,300	Common Stock	6,000
Accounts Payable	3,300	Note Payable	5,000
Accounts Receivable	600	Supplies	700

Requirements

1. What type of business organization is Fitness Fanatics?
2. Prepare the balance sheet of the business at March 31, 2018.
3. What does the balance sheet report?

E1-21A. Types of accounts and income statement preparation (*Learning Objectives 5 & 6*) 15–20 min.

Selected accounts of Annis Consulting, Inc., a financial services business, have the following balances at December 31, 2018, the end of its first year of operations. During the year, Laura Annis, the only stockholder, bought $27,000 of stock in the business.

Office Furniture	$ 21,000	Rent Expense	$40,000
Utilities Expense	13,500	Cash	5,400
Accounts Payable	5,200	Office Supplies	1,500
Note Payable	20,000	Salaries Expense	41,000
Service Revenue	141,500	Salaries Payable	2,000
Accounts Receivable	4,500	Property Tax Expense	2,000
Supplies Expense	3,800	Equipment	34,000

Requirements

1. Identify each amount shown as an asset, liability, revenue, or expense.
2. Prepare the income statement of Annis Consulting, Inc., for the year ended December 31, 2018. What is the result of operations for 2018?
3. Assuming the balance in Retained Earnings on December 31, 2018, was $36,200, what was the amount of the dividends during the year? Answer by preparing a statement of retained earnings to solve for the dividends. Recall that the business has just completed its first year and has no beginning balance for retained earnings.

E1-22A. Using the accounting equation to determine net income (*Learning Objectives 5 & 6*) 15–20 min.

Presented here is information for Anderson Sign, Inc., for the year ended August 31, 2018.

Anderson Sign, Inc.	
Beginning:	
Assets	$133,000
Liabilities	25,000
Ending:	
Assets	$154,000
Liabilities	70,000
Stockholders' Equity:	
Sale of Stock	$19,000
Payment of Dividends	40,000

Requirements

1. What is the beginning stockholders' equity of Anderson Sign, Inc.?
2. What is the ending stockholders' equity of Anderson Sign, Inc.?
3. What is the net income or net loss for the year?

Exercises (Group B)

E1-23B. Basic accounting equation (*Learning Objective 5*) 10–15 min.

Determine the missing amounts in the following accounting equations.

	Assets	=	Liabilities	+	Stockholders' Equity
Lundy Plumbing, Corp.	?	=	$50,500	+	$13,300
Sanchez Hardware, Inc.	$ 95,000	=	?	+	$34,000
Cutter & Son Cleaners, Inc.	$117,900	=	$88,200	+	?

E1-24B. Basic accounting equation (*Learning Objective 5*) 10–15 min.

Amicho Deli had $94,000 of total assets and $10,000 of total stockholders' equity at July 31, 2018. At July 31, 2019, Amicho Deli had assets totaling $151,000 and stockholders' equity totaling $112,000.

After analyzing the data, answer the following questions:

1. What was the amount of the increase or decrease in liabilities in 2019?
2. Identify a possible reason for the change in liabilities during the year.

E1-25B. Basic accounting equation (*Learning Objective 5*) 10–15 min.

Tony's Advertising started a business in 2018 with total assets of $50,000 and total liabilities of $18,000. At the end of 2018, Tony's Advertising's total assets were $39,000 and total liabilities were $10,000.
After analyzing the data, answer the following questions:

1. What was the amount of the increase or decrease in stockholders' equity?
2. Identify two possible reasons for the change in stockholders' equity during the year.

E1-26B. Using the accounting equation to determine net income (*Learning Objectives 5 & 6*) 15–20 min.

The balance sheet data for Bell Computers, Inc., at August 31, 2018, and September 30, 2018, follow:

	Aug 31, 2018	Sep 30, 2018
Total Assets	$125,000	$175,000
Total Liabilities	69,000	125,000
Common Stock	45,000	45,000
Total Stockholders' Equity	?	?

Requirement

1. The following are three *independent* assumptions about the business during September. For each assumption, compute the amount of net income or net loss during September 2018. Find the solution by preparing the statement of retained earnings. First, use the amounts of total assets, total liabilities, and common stock given previously and the accounting equation to determine the beginning and ending retained earnings amounts. Then plug those and the other amount given in each assumption into the statement of retained earnings to determine the net income or net loss.
   a. The business paid no dividends.
   b. The business paid $8,000 of dividends.
   c. The business paid $16,000 of dividends.

E1-27B. Transaction analysis (*Learning Objective 5*) 15–20 min.

Trina Lynch opened a medical practice titled Trina Lynch M.D., Inc. During July, the first month of operations, the business experienced the following events:

Jul	2	Lynch bought $80,000 of common stock in the business by opening a bank account in the name of Trina Lynch M.D., Inc.
	6	The business paid $65,000 cash for land with the intention of building an office building on the land.
	11	The business purchased medical supplies for $800 on account.
	15	The business officially opened for business.
	17	The business treated patients and earned service revenue of $12,000, receiving cash.
	19	The business paid office rent, $2,400.
	22	The business sold supplies to another doctor for $300 cash, the cost of those supplies.
	25	The business received a $235 utility bill in the mail. The bill will be paid in 30 days.
	30	The business paid $250 on account related to the July 11 purchase.

Requirement

1. Analyze the effects of these events on the accounting equation of the medical practice of Trina Lynch M.D., Inc. Use headings for Cash, Medical Supplies, Land, Accounts Payable, Common Stock, Service Revenue, Rent Expense, and Utilities Expense.

E1-28B. Types of business organizations and balance sheet preparation (*Learning Objectives 5 & 6*) 10–15 min.

The following are the balances of the assets, liabilities, and equity of Jerome's Coffee Shop at March 31, 2018:

Cash	$22,000	Office Equipment	$15,100
Retained Earnings	30,900	Common Stock	2,000
Accounts Payable	1,800	Note Payable	5,000
Accounts Receivable	2,100	Supplies	500

Requirements

1. What type of business organization is Jerome's Coffee Shop?
2. Prepare the balance sheet of the business at March 31, 2018.
3. What does the balance sheet report?

E1-29B. Types of accounts and income statement preparation (*Learning Objectives 5 & 6*) 15–20 min.

Selected accounts of Andover Consulting, Inc., a financial services business, have the following balances at December 31, 2018, the end of its first year of operations. During the year, Lynne Andover, the only stockholder, bought $15,000 of stock in the business.

Office Furniture	$ 30,000	Rent Expense	$36,000
Utilities Expense	14,200	Cash	19,000
Accounts Payable	5,200	Office Supplies	1,100
Notes Payable	18,000	Salaries Expense	50,000
Service Revenue	139,500	Salaries Payable	2,500
Accounts Receivable	5,500	Property Tax Expense	2,200
Supplies Expense	4,000	Equipment	40,000

Requirements

1. Identify each amount shown as an asset, liability, revenue, or expense.
2. Prepare the income statement of Andover Consulting, Inc., for the year ended December 31, 2018. What is the result of operations for 2018?
3. Assuming the balance in Retained Earnings on December 31, 2018, was $18,100, what was the amount of the dividends during the year? Answer by preparing a statement of retained earnings to solve for the dividends. Recall that the business has just completed its first year and has no beginning balance for retained earnings.

E1-30B. Using the accounting equation to determine net income (*Learning Objectives 5 & 6*) 15–20 min.

Presented here is information for Eliason, Inc., for the year ended August 31, 2018.

Eliason, Inc.	
Beginning:	
Assets	$ 44,000
Liabilities	20,000
Ending:	
Assets	$104,000
Liabilities	25,000
Stockholders' Equity:	
Sale of Stock	$ 12,000
Payment of Dividends	60,000

Requirements

1. What is the beginning stockholders' equity of Eliason, Inc.?
2. What is the ending stockholders' equity of Eliason, Inc.?
3. What is the net income or net loss for the year?

MyLab Accounting

Problems (Group A)

P1-31A. Transaction analysis and the calculation of net income (*Learning Objective 5*) 20–25 min.

Shanna Peters worked as an accountant at a local accounting firm for five years after graduating from college. She recently opened her own accounting practice, which she operates as a corporation. The name of the new entity is Peters and Associates, Inc. Shanna experienced the following events during the first month of operations. Some of the events were personal and did not affect the accounting practice. Others were business transactions and should be accounted for by the business.

Jun	3	Received $70,000 cash proceeds from refinancing her house.
	5	$95,000 of common stock in the business was sold to Shanna Peters. The cash proceeds were deposited in a new business bank account titled Peters and Associates, Inc.
	7	Paid $450 cash for office supplies for the new accounting practice.
	9	Purchased $4,700 of office furniture for the accounting practice and agreed to pay the vendor within three months.
	10	Shanna sold 500 shares of Microsoft stock, which she had owned for several years, receiving $20,750 cash. The cash from the sale of stock was deposited in her personal bank account.
	14	A representative of a large company telephoned Shanna and told her of the company's intention to hire Peters and Associates, Inc., as its accountants.
	20	Finished accounting work for a client and sent the client a bill for $3,800. The client is expected to pay within two weeks.
	27	Paid office rent, $1,500.
	29	Paid $2,000 on account from the June 9th transaction.
	30	Paid $500 of dividends to shareholders of Peters and Associates, Inc.

Requirements

1. Enter each transaction in the expanded accounting equation of Peters and Associates, Inc., as needed, calculating new balances after each transaction.
2. Determine the following items:
   a. Total assets
   b. Total liabilities
   c. Total stockholders' equity
   d. Net income or net loss for June

P1-32A. Income statement and balance sheet transactions; preparing the income statement and balance sheet (*Learning Objectives 5 & 6*) 25–30 min.

Dori Cruz started an interior design company called Interiors by Design, Inc., on April 1, 2018. The following amounts summarize the financial position of her business on April 14, 2018, after the first two weeks of operations:

Assets							Liabilities		Stockholders' Equity					
									Common Stock		Retained Earnings			
Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Service Revenue	−	Salaries Expense	−	Dividends
$1,380	+	$3,820	+	0	+	$28,000	=	$4,500	+	$24,000	+	$6,700	−	$2,000	−	0

During the remainder of April, the following events occurred:

a. Cruz received $8,000 as a gift and used it to buy common stock in the business
b. Paid off the beginning balance of Accounts Payable
c. Performed services for a client and received cash of $3,500
d. Collected cash from a customer on account, $400
e. Purchased supplies on account, $1,300
f. Consulted on the interior design of a major office building and billed the client for services performed, $5,500
g. Sold an additional $10,000 of common stock in the business
h. Incurred and paid salaries of $2,500
i. Sold supplies at cost to another interior designer for $175 cash
j. Paid dividends of $800 to the stockholders of Interiors by Design, Inc.

Requirements

1. Enter the remaining transactions for the month of April into the expanded accounting equation, calculating new balances after each transaction.
2. Prepare the income statement of Interiors by Design, Inc., for the month ended April 30, 2018.
3. Prepare the statement of retained earnings of Interiors by Design, Inc., for the month ended April 30, 2018.
4. Prepare the balance sheet of Interiors by Design, Inc., at April 30, 2018.

P1-33A. Preparing the income statement, statement of retained earnings, and balance sheet (*Learning Objective 6*) 20–25 min.

Resto Motors, Inc., restores antique automobiles. The retained earnings balance of the corporation was $22,400 at December 31, 2017. During 2018, the corporation paid $85,000 in dividends to its stockholders. At December 31, 2018, the business's accounting records show these balances:

Accounts Receivable	$ 8,700	Cash	$ 13,800
Note Payable	15,000	Accounts Payable	2,900
Retained Earnings	?	Advertising Expense	4,700
Salaries Expense	33,400	Service Revenue	150,500
Equipment	57,000	Common Stock	30,000
Insurance Expense	3,300	Rent Expense	10,800
Utilities Expense	2,950	Supplies	1,150

Quick solution:

a. Net income = $95,350

b. Ending Retained earnings = $32,750

c. Total assets = $80,650

Requirements

1. Identify each amount shown as an asset, liability, or stockholders' equity.
2. Prepare the following financial statements for Resto Motors, Inc.:
   a. Income statement for the year ended December 31, 2018
   b. Statement of retained earnings for the year ended December 31, 2018
   c. Balance sheet at December 31, 2018

P1-34A. Preparing the income statement and balance sheet; identifying certain financial information (*Learning Objective 6*) 25–30 min.

Presented here are the amounts of Assets, Liabilities, Stockholders' Equity, Revenues, and Expenses of Extreme Sports, Inc., at October 31, 2018. The items are listed in alphabetical order.

Accounts Payable	$ 18,000	Interest Expense	$ 5,500
Accounts Receivable	14,000	Land	35,000
Advertising Expense	19,000	Note Payable	65,000
Building	125,000	Property Tax Expense	4,300
Cash	18,000	Rent Expense	22,000
Common Stock	20,000	Salaries Expense	61,000
Dividends	36,000	Salaries Payable	6,000
Equipment	50,000	Service Revenue	190,000
Insurance Expense	2,800	Supplies	1,300

The retained earnings balance of the business was $94,900 at October 31, 2017.

Requirements

1. Identify each amount shown as an asset, liability, or stockholders' equity.
2. Prepare the company's income statement and statement of retained earnings for the year ended October 31, 2018.
3. Prepare the company's balance sheet at October 31, 2018.
4. Answer these questions about the company:
   a. What was the profit or loss for the year?
   b. What was the increase or decrease of retained earnings for the year?
   c. What is the amount of economic resources on October 31, 2018?
   d. What is the amount owed on October 31, 2018?

P1-35A. Error analysis and preparation of balance sheet (*Learning Objective 6*) 20–25 min.

The IT manager of Valley Realty, Inc., prepared the balance sheet of the company while the accountant was ill. The balance sheet contains numerous errors. In particular, the IT manager knew that the balance sheet should balance, so she plugged in the retained earnings amount to achieve this balance. The retained earnings amount, however, is not correct. All other amounts are accurate, but some are out of place.

Valley Realty, Inc.
Balance Sheet
Month Ended November 30, 2018

ASSETS		LIABILITIES	
Cash	$ 9,400	Accounts Payable	$ 1,800
Rent Expense	1,900	Utilities Expense	700
Supplies Expense	500	Accounts Receivable	3,200
Salaries Payable	2,150	Notes Payable	5,300
Equipment	17,300		
		STOCKHOLDERS' EQUITY	
		Common Stock	9,000
		Supplies	440
		Retained Earnings	10,810
		Total Stockholders' Equity	20,250
Total Assets	$31,250	Total Liabilities & Stockholders' Equity	$31,250

Requirement

1. Prepare a new, corrected balance sheet for Valley Realty, Inc.

Problems (Group B)

P1-36B. Transaction analysis and the calculation of net income (*Learning Objective 5*) 20–25 min.

Darin Oliver worked as an accountant at a local accounting firm for five years after graduating from college. He recently opened his own accounting practice, which he operates as a corporation. The name of the new entity is Oliver and Associates, Inc. Darin experienced the following events during the first month of operations. Some of the events were personal and did not affect the accounting practice. Others were business transactions and should be accounted for by the business.

Nov	3	Received $80,000 cash proceeds from refinancing his house.
	5	$55,000 of common stock in the business was sold to Darin Oliver. The cash proceeds were deposited in a new business bank account titled Oliver and Associates, Inc.
	7	Paid $450 cash for office supplies for the new accounting practice.
	9	Purchased $3,800 of office furniture for the accounting practice and agreed to pay the vendor within three months.
	10	Darin sold 130 shares of Apple stock, which he had owned for several years, receiving $16,500 cash. The cash from the sale of stock was deposited in his personal bank account.
	14	A representative of a large company telephoned Darin and told him of the company's intention to hire Oliver and Associates, Inc., as its accountants.
	20	Finished accounting work for a client and sent the client a bill for $4,000. The client is expected to pay within two weeks.
	27	Paid office rent, $1,400.
	29	Paid $2,500 on account from the November 9th transaction.
	30	Paid $800 of dividends to shareholders of Oliver and Associates, Inc.

Requirements

1. Enter each transaction in the expanded accounting equation of Oliver and Associates, Inc., as needed, calculating new balances after each transaction.
2. Determine the following items:
   - **a.** Total assets
   - **b.** Total liabilities
   - **c.** Total stockholders' equity
   - **d.** Net income or net loss for November

P1-37B. Income statement and balance sheet transactions; prepare the income statement and balance sheet (*Learning Objectives 5 & 6*) 25–30 min.

Breanna Baxter started an interior design company called Interiors on Demand, Inc., on June 1, 2018. The following amounts summarize the financial position of her business on June 14, 2018, after the first two weeks of operations:

Assets								Liabilities		Stockholders' Equity						
										Common Stock		Retained Earnings				
Cash	+	Accounts Receivable	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	+	Service Revenue	−	Salaries Expense	−	Dividends
$1,610	+	$3,070	+	0	+	$25,000	=	$4,500	+	$20,000	+	$6,700	−	$1,520	−	0

During the remainder of June, the following events occurred:

a. Baxter received $16,000 as a gift and used it to buy common stock in the business

b. Paid off the beginning balance of Accounts Payable

c. Performed services for a client and received cash of $5,000

d. Collected cash from a customer on account, $1,150

e. Purchased supplies on account, $800

f. Consulted on the interior design of a major office building and billed the client for services performed, $4,500

g. Sold an additional $9,000 of common stock in the business

h. Incurred and paid salaries of $2,200

i. Sold supplies at cost to another interior designer for $250 cash

j. Paid dividends of $1,000 to the stockholders of Interiors on Demand, Inc.

Requirements

1. Enter the remaining transactions for the month of June into the expanded accounting equation, calculating new balances after each transaction.
2. Prepare the income statement of Interiors on Demand, Inc., for the month ended June 30, 2018.
3. Prepare the statement of retained earnings of Interiors on Demand, Inc., for the month ended June 30, 2018.
4. Prepare the balance sheet of Interiors on Demand, Inc., at June 30, 2018.

P1-38B. Prepare the income statement, statement of retained earnings, and balance sheet (*Learning Objective 6*) 20–25 min.

Classic Cars, Inc., restores antique automobiles. The retained earnings balance of the corporation was $22,300 at December 31, 2017. During 2018, the corporation paid $20,000 in dividends to its stockholders. At December 31, 2018, the business's accounting records show these balances:

Accounts Receivable	$11,600	Cash	$12,300
Note Payable	18,000	Accounts Payable	6,150
Retained Earnings	?	Advertising Expense	3,100
Salaries Expense	22,600	Service Revenue	68,900
Equipment	65,000	Common Stock	32,000
Insurance Expense	2,800	Rent Expense	7,700
Utilities Expense	1,400	Supplies	850

Requirements

1. Identify each amount shown as an asset, liability, or stockholders' equity.
2. Prepare the following financial statements for Classic Cars, Inc.:
   a. Income statement for the year ended December 31, 2018
   b. Statement of retained earnings for the year ended December 31, 2018
   c. Balance sheet at December 31, 2018

P1-39B. Preparing the income statement and balance sheet; identifying certain financial information (*Learning Objective 6*) 25–30 min.

Presented here are the amounts of Assets, Liabilities, Stockholders' Equity, Revenues, and Expenses of The Fitness Guru, Inc., at August 31, 2018. The items are listed in alphabetical order.

Accounts Payable	$ 15,000	Interest Expense	$ 5,000
Accounts Receivable	14,000	Land	37,000
Advertising Expense	15,000	Note Payable	70,000
Building	135,000	Property Tax Expense	4,500
Cash	16,000	Rent Expense	22,000
Common Stock	70,000	Salaries Expense	92,000
Dividends	29,000	Salaries Payable	5,000
Equipment	40,000	Service Revenue	166,000
Insurance Expense	2,200	Supplies	1,400

The retained earnings balance of the business was $87,100 at August 31, 2017.

Requirements

1. Identify each amount shown as an asset, liability, or stockholders' equity.
2. Prepare the company's income statement and statement of retained earnings for the year ended August 31, 2018.
3. Prepare the company's balance sheet at August 31, 2018.
4. Answer these questions about the company:
   a. What was the profit or loss for the year?
   b. What was the increase or decrease of retained earnings for the year?
   c. What is the amount of economic resources on August 31, 2018?
   d. What is the amount owed on August 31, 2018?

P1-40B. Error analysis and preparation of balance sheet (*Learning Objective 6*) 20–25 min.

The IT manager of Highland Realty, Inc., prepared the balance sheet of the company while the accountant was ill. The balance sheet contains numerous errors. In particular, the IT manager knew that the balance sheet should balance, so she plugged in the retained earnings amount to achieve this balance. The retained earnings amount, however, is not correct. All other amounts are accurate, but some are out of place.

Highland Realty, Inc.
Balance Sheet
Month Ended September 30, 2018

ASSETS		LIABILITIES	
Cash	$ 9,000	Accounts Payable	$ 2,000
Rent Expense	2,400	Utilities Expense	400
Supplies Expense	150	Accounts Receivable	1,400
Salaries Payable	1,100	Notes Payable	5,700
Equipment	8,300		
		STOCKHOLDERS' EQUITY	
		Common Stock	9,000
		Supplies	600
		Retained Earnings	1,850
		Total Stockholders' Equity	11,450
Total Assets	$20,950	Total Liabilities & Stockholders' Equity	$20,950

Requirement

1. Prepare a new, corrected balance sheet for Highland Realty, Inc.

Continuing Exercise

This exercise is the first exercise in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 3. Sensations Salon, Inc., was opened by Sharmaine Crosswhite in her home and completed the following transactions during the month of May.

May	1	Received $1,500 and issued 500 shares of common stock to Sharmaine Crosswhite. Deposited this amount in a bank account in the name of Sensations Salon, Inc.
	3	Purchased on account styling chairs, $1,600, and professional clippers, $308. The equipment is expected to remain in service for three years.
	5	Purchased $125 of supplies. Wrote check #1 from the new bank account.
	6	Performed services for clients on account, $375.
	17	Completed services for clients, received cash $275.
	28	Paid the utility bill, $65. Wrote check #2 from the new bank account.
	30	Received $150 on account from services performed on May 6.

Requirement

1. Analyze the effects of Sensations Salon, Inc.'s transactions on the accounting equation. Include these headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Common Stock, Retained Earnings, Service Revenue, and Utilities Expense. Determine the ending balances in each account on May 31.

In Chapter 2, we will account for these same transactions a different way—as the accounting is actually performed in practice.

Continuing Problem

This problem is the first problem in a sequence that begins an accounting cycle. The cycle is continued in Chapter 2 and completed in Chapter 3.

Adam Mazella recently left his job to open his own gym equipment repair business. Adam took all of the money he had in his personal savings account and used it to open Fitness Equipment Doctor, Inc., on March 1, 2018. Presented next are the transactions for the first month of operations for Fitness Equipment Doctor, Inc.:

March 1	Adam invested $22,000 cash and a used truck with a fair market value of $13,000 in the business in exchange for the company's common stock.
3	Paid $3,600 cash to purchase equipment.
7	Purchased $900 of supplies on account.
12	Performed services for cash customers and received $850.
15	Incurred and paid salaries of $620 to the office receptionist.
16	Sold the company truck for $13,000.
18	Signed a note payable for $35,800 to purchase a new truck.
21	Performed $3,200 of services on account for a local hotel chain.
27	Paid $150 of the amount owed from the purchase of supplies on March 7.
30	Received $1,900 on account from credit customers.
31	Received the utility bill for the month of March, $250. The bill is not due until April 15.
31	Paid $1,500 dividends to the shareholder, Adam Mazella.

Requirements

1. Enter the transactions for Fitness Equipment Doctor, Inc., for the month of March into the expanded accounting equation. Calculate the ending balances at March 31.
2. Prepare the income statement for Fitness Equipment Doctor, Inc., for the first month of operations.
3. Prepare the statement of retained earnings for Fitness Equipment Doctor, Inc., for the first month of operations.
4. Prepare the balance sheet for Fitness Equipment Doctor, Inc., at March 31.
5. Did Adam make a wise decision leaving his job to start Fitness Equipment Doctor, Inc.?

Continuing Financial Statement Analysis Problem

Let's look at Dick's Sporting Goods (Dick's), the largest retailer of sporting goods in the United States. Think about Dick's, all its stakeholders, what products it sells, and how and where it sells its products. Think about all the employees who work for Dick's and the assets Dick's needs to operate. Think about the business of Dick's.

Now go to Dick's website at www.dickssportinggoods.com. At the bottom of the page, click on **Investor Relations**. The Investor Relations section of Dick's website contains a lot of information shareholders (also called stockholders) want and need. Next, click on **Company Information**. Navigate through this website and read all about the company. Then answer the following questions:

1. What is the mission statement of the business? What does it say about value?
2. What type of business is Dick's? Is it a service company, a merchandising company, or a manufacturing company?
3. What products does Dick's sell? Where does it get the products it sells?
4. Who are Dick's customers?
5. Now consider Dick's stock price. On January 30, 2017, you would pay $52.17 to own one share of Dick's stock. When you add the value of all the shares of stock together, Dick's is valued at over $4 billion. That's a lot of money. Do you think Dick's is worth that much money? What role do you think accounting plays in helping owners (shareholders) decide Dick's value?

Apply Your Knowledge

Ethics in Action

Case 1. Lisa Hill and her husband Mike were the owners of LM Enterprises, Inc. They applied for a small business loan, and the bank requested the most recent business financial statements. When Lisa compiled the balance sheet, she noticed that the business's assets and related stockholders' equity were small. Accordingly, she told Mike that they should contribute some of their personal assets to the business so the assets and equity would appear much larger and thus the bank would more likely agree to the business loan. Mike agreed that the balance sheet would appear stronger with more assets and equity, but his concern was with the income statement. The sales for the latest period were low, which resulted in a slight net loss because expenses were slightly higher than revenues. Mike reasoned that contributing assets would show a stronger balance sheet but felt something had to be done to also improve the income statement. He then told Lisa that their business could "sell" back some of the assets they had contributed and report higher sales on the income statement, which would result in net income rather than the actual net loss. Lisa did not feel comfortable buying back assets from their business just to increase reported sales.

Discuss any ethical concerns you may have with Lisa's proposal. Discuss any ethical concerns you may have with Mike's proposal. Do you think it is ethical for a business to "dress up" its financial statements when applying for a loan?

Case 2. Blackstone, Inc., was in the final phase of completing a land development project it started earlier in the year. Blackstone, Inc., had acquired 50 acres of raw land for $400,000 and then spent an additional $1,700,000 in land development costs to create a new subdivision with 100 residential lots. With a total cost of $2,100,000 and 100 lots, each lot had a cost of $21,000; however, the lots were listed for sale at $48,000 per lot. Blackstone, Inc., was applying for a business loan and needed to provide current financial statements to the bank. Amy Clark, the company president, wanted to report the total current value of the lots, $4,800,000 (100 lots × 48,000 per lot), rather than the total cost currently listed on the balance sheet, $2,100,000. Dan Sullivan, the company accountant, told Amy the lots were inventory and should be reported on the balance sheet at the $2,100,000 rather than the fair market value.

Should the balance sheet for Blackstone, Inc., list the lots at the total cost of $2,100,000 or the total selling price of $4,800,000? Could Blackstone, Inc., provide one balance sheet using historical cost and another balance sheet using market value?

Know Your Business

Financial Analysis

Purpose: To help familiarize you with the financial reporting of a real company to further your understanding of the chapter material you are learning.

Each chapter will have a financial statement case that focuses on material contained in that chapter. You will be asked questions and will then refer to Appendix A at the end of the book, where you will find the annual report for Columbia Sportswear Company. Use the annual report to answer these questions. As you progress through each chapter, you will gain a real understanding of actual corporate financial reporting in addition to the basic accounting concepts you are learning within each textbook chapter. This added learning experience will reinforce your understanding of accounting.

Requirements

1. Look at all the financial statements starting on page 663 of Appendix A and see whether you can identify the balance sheet, income statement, and statement of cash flows. (Note that the term *Consolidated* simply means "combined.")
2. What was the total amount of assets Columbia Sportswear reported as of December 31, 2016? (Keep in mind that the numbers are in thousands.) Did the total assets increase or decrease from December 31, 2015?

3. Did you see that Columbia Sportswear titled its income statement "Statements of Operations"? Were you able to identify it? (Note that some companies use this title.)
4. What was the total amount of revenues (net sales) Columbia Sportswear reported for the year ended December 31, 2016? (Keep in mind that the numbers are in thousands.) Did the revenues increase or decrease from the previous years presented?

Industry Analysis

Purpose: To help you understand and compare the performance of two companies in the same industry.

Go to the Columbia Sportswear Company Annual Report located in Appendix A and find the Consolidated Balance Sheets on page 663. Now access the 2016 Annual Report for Under Armour, Inc. To do this online, go to the company's website at www.underarmour.com. At the very bottom of the page, look for "About Under Armour" and then click on **Investor Relations**. Next, click on **Financials** on the left-hand side of the page and then click on **Annual Report & Proxy**. Now, look for the link to download the 2016 annual report. The Consolidated Balance Sheet is located on page 57.

Columbia Sportswear Company and Under Armour, Inc., are in the same industry: manufacturing and selling sportswear. It is helpful to compare a company's financial data against those of other companies in their industry.

Requirement

1. Look at the data from the Consolidated Balance Sheets at December 31, 2016, for each of the companies. Which company's stockholders have a higher claim to their company's assets? To find out, divide the total stockholders' equity for each company by its total liabilities and stockholders' equity. For Columbia Sportswear, use the "Total Columbia Sportswear Company shareholders' equity" amount, which does not include an item titled "Non-controlling interest."

Small Business Analysis

Purpose: To help you understand the importance of cash flows in the operation of a small business.

Think about operating a business like the Millers did when they created the Bold City Brewery. Your business is called BCS Consultants, Inc. You just received your year-end financial statements from your CPA and you notice one very disturbing item. The net income from your income statement shows $36,000! Your very first thought is "where is it?" Then you look at your cash balance and see that it decreased $8,000 from last year to this year. You're thinking there has to be something wrong here. So, you call up your CPA and ask for a meeting to discuss this obvious error. After all, how can you possibly have a positive net income and have your cash balance *decrease*?

At the meeting, the CPA lays out the financial statements in front of you and begins to explain how this would have happened. Following are a condensed income statement, statement of retained earnings, and balance sheet:

BCS Consultants, Inc.
Income Statement
For the Year Ended December 31, 2018

Total Revenue	$142,000
Total Expenses	106,000
Net Income	$ 36,000

BCS Consultants, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 2018

Beginning Retained Earnings		$ 84,000
Net Income	$ 36,000	
Dividends Paid	(15,000)	21,000
Ending Retained Earnings		$105,000

BCS Consultants, Inc.
Balance Sheet
December 31, 2018 & 2017

	2018	2017
Assets:		
Cash	$ 30,000	$ 38,000
Equipment	158,000	146,000
Total Assets	$188,000	$184,000
Liabilities:		
Notes Payable—Bank	$ 58,000	$ 75,000
Stockholder's Equity:		
Common Stock	25,000	25,000
Retained Earnings	105,000	84,000
Total Stockholders' Equity	130,000	109,000
Total Liabilities and Stockholders' Equity	$188,000	$184,000

Requirement

1. By looking at the three financial statements, can you anticipate what the CPA is going to tell you about why the cash decreased even though you had net income for the year? What changed from 2017 to 2018? Are transactions that affect the income statement the only transactions that affect your cash balance?

Written Communication

You just received an e-mail from a potential new client who contacted you from your website. This client has indicated that he or she is planning to start a new business. The client is concerned about legal liability as well as taxation and is questioning what type of legal formation he or she should choose. Also, the client is wondering exactly what role an accountant would have in running his or her business.

Requirement

1. Prepare an e-mail to this potential client, addressing his or her questions about the different types of legal forms of business and why he or she needs to have an accountant involved in the business.

Self Check Answers

1. c 2. d 3. c 4. c 5. a 6. b 7. b 8. c 9. a 10. d 11. true 12. c

CHAPTER 2

Analyzing and Recording Business Transactions

Learning Objectives

1. Define accounts and understand how they are used in accounting
2. Explain debits, credits, and the double-entry system of accounting
3. Demonstrate the use of the general journal and the general ledger to record business transactions
4. Use a trial balance to prepare financial statements

Business, Accounting, and You

Think about a pub or brewery like the Bold City Brewery.[1] What do you see? You see people ordering and drinking beverages. You see employees managing inventory, serving customers, and collecting payments. Everywhere you look, you see business transactions. You see business in action.

Now think about this: How does the Bold City Brewery, or any business, keep up with all those transactions? How does a business keep track of all its sales (revenue), expenses, assets, liabilities, and other activities? There must be a "scorekeeper." There must be a systematic process that recognizes, measures, records, and reports these business transactions in an understandable, reliable, and relevant manner. There must be a way to capture the cause and effect of each transaction. That's the role of accounting in business.

For accounting information to be understandable, reliable, and relevant, accountants have rules. GAAP, as noted in Chapter 1, sets the rules for recognizing and measuring business transactions. The rules for recognizing and measuring transactions will be explored throughout the book. However, the rules for recording and reporting business transactions are based on a set of proven techniques that have evolved over time. The result is a set of standard, universally accepted procedures that work. The key to using these techniques and procedures is understanding (1) accounts and (2) double-entry accounting.

Why is this important to you? Whether you want to be an accountant or a manager, you need to understand how business transactions are recorded and reported. The final report card, good or bad, is a result of this recording process. Would you want to play a game where you do not understand how the score is recorded and ultimately reported? Probably not. Understanding how accountants record business transactions is very important.

[1]The Bold City Brewery is located in Jacksonville, Florida. For more information about the Bold City Brewery, go to www.boldcitybrewery.com/home.php.

How Are Accounts Used to Keep Business Transactions Organized?

1 **Define accounts and understand how they are used in accounting**

Accounts The basic summary device of accounting; the detailed record of all changes in a specific asset, liability, or stockholders' equity item as a result of transactions.

As we discussed in Chapter 1, accounting provides useful information to various users. For that information to be useful, it has to be detailed. Therefore, to convey the detail required, accountants create many categories in which to track information. These categories are referred to as **accounts**. We have already seen accounts in use. When recording transactions in the accounting equation in Chapter 1, we created accounts such as Cash, Equipment, and Accounts Payable.

Organizing Accounts

Numbering helps keep accounts organized. Account numbers usually have two or more digits. The first digit indicates the type of account. In general, if an account starts with:

- 1, it is an asset account.
- 2, it is a liability account.
- 3, it is a stockholders' equity account other than a revenue or expense account.
- 4, it is a revenue account.
- 5, it is an expense account.
- 9, it is an other revenue or expense account. These are items that are outside of a company's principle business activities, such as interest or gains/losses on the sale of assets.

Accounts that start with 6, 7, or 8 may also be used by some businesses to record expenses.

After the first digit, the remaining digits in an account number are used to specify the exact account. For example, Cash may be numbered 101 and Accounts Receivable may be numbered 131. A gap in numbers is usually left between the different accounts to allow for additional accounts to be added later. A listing of all of the accounts is referred to as a **chart of accounts**. The accounts are typically listed in the chart of accounts in the order they appear in the accounting equation. Therefore, assets would be listed first, followed by the liabilities, and then the stockholders' equity accounts. Types of accounts typical for many businesses are discussed in the next section.

Chart of accounts A list of all the accounts of a business and the numbers assigned to those accounts.

Assets

As described in Chapter 1, assets represent things of value that a business has. Most businesses use the following asset accounts:

- **Cash.** Cash typically includes the business's bank account balance, paper currency, coins, and checks.
- **Accounts Receivable.** A business may sell goods or services in exchange for a promise of a future cash receipt. Such sales are said to be made "on credit" or "on account." The Accounts Receivable account reflects the amounts that customers owe the business for goods or services that have already been provided. In other words, it shows how much money the company can expect to *receive* from customers in the future.
- **Notes Receivable.** A business may sell goods or services or loan money and receive a **promissory note**. A promissory note is a written promise that the customer or borrower will pay a fixed amount of money by a certain date. Notes Receivable reflects the amount of the promissory notes that the business expects to collect in cash at a later date.
- **Prepaid Expenses.** A business often pays certain expenses, such as rent and insurance, in advance. A prepaid expense is an asset because the prepayment provides

Promissory note A written pledge to pay a fixed amount of money at a later date.

a future benefit for the business. A separate asset account is used for each prepaid expense. Prepaid Rent and Prepaid Insurance are examples of prepaid expense accounts.

- **Land.** The Land account is used to keep track of the cost of land a business owns and uses in its operations.
- **Buildings.** The cost of a business's buildings, offices, warehouses, and so on is recorded in the Buildings account.
- **Equipment, Furniture, and Fixtures.** A business typically has a separate asset account for each type of equipment. Examples include Computer Equipment, Office Equipment, Store Equipment, and Furniture and Fixtures.

Liabilities

As defined in Chapter 1, liabilities are amounts owed to third parties. A business generally has fewer liability accounts than asset accounts because a business's liabilities can be summarized in a few categories, such as:

- **Accounts Payable.** A business may purchase goods or services in exchange for a promise of future payment. Such purchases are said to be made on credit or on account. The Accounts Payable account reflects how much cash the business must pay to suppliers for goods or services that have already been received.
- **Notes Payable.** Notes Payable represents amounts the business must pay because it signed promissory notes to borrow money or to purchase goods or services.
- **Accrued Liabilities.** An accrued liability is a liability for an expense that has been incurred but has not yet been paid. Taxes Payable, Interest Payable, and Salaries Payable are examples of accrued liability accounts.

Stockholders' Equity

As we saw in Chapter 1, the owners' claim to the assets of the business is called Stockholders' Equity. We have already discussed the different types of stockholders' equity accounts and what they're used for, but they are listed here again for review.

- **Common Stock.** The Common Stock account represents the investment of assets, usually cash, the stockholders have invested into a business in exchange for the company's stock.
- **Retained Earnings.** The Retained Earnings account tracks the cumulative earnings of the business since it began, less any dividends given to stockholders.
- **Revenues.** Increases in Retained Earnings (and, therefore, Stockholders' Equity) created by selling goods or services to customers are called revenues. This account represents amounts *earned* by the company even if the company has not yet been paid for the goods and services provided. A business may have several revenue accounts, depending on how many ways it earns its revenue.
- **Expenses.** Expenses are decreases in Retained Earnings (and, therefore, Stockholders' Equity) from using resources to deliver goods and services to customers. A business needs a separate account for each type of expense, such as Insurance Expense, Rent Expense, Salaries Expense, and Utilities Expense. Businesses often have numerous expense accounts because many different types of costs are associated with providing goods and services to customers.
- **Dividends.** This account reflects the amount of earnings that have been distributed to the stockholders. Dividends decrease Retained Earnings (and therefore Stockholders' Equity).

What Is Double-Entry Accounting?

2 **Explain debits, credits, and the double-entry system of accounting**

Double-entry accounting The rule of accounting that specifies every transaction involves at least two accounts and is recorded with equal amounts of debits and credits.

Debit The left side of any account; an entry made to the left side of an account.

Credit The right side of any account; an entry made to the right side of an account.

T-account An informal account form used to summarize transactions, where the top of the T holds the account title and the base divides the debit and credit sides of the account.

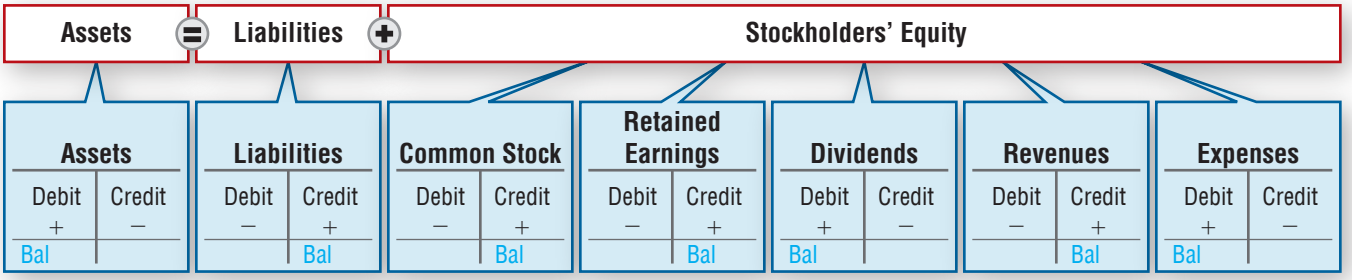
In Chapter 1, we learned that every time we enter a transaction in the accounting equation, it affects at least two accounts. In accounting, the requirement that every transaction affect at least two accounts is called **double-entry accounting**. To simplify the process of accounting, each account is broken down into two sides. This can be visualized as a large T. For each account, one side of the T will represent an increase to the account, while the other side represents a decrease. Whether it is the left side of the T or the right side that increases the account depends on the type of account. Some accounts will increase on the left side and some will increase on the right side. In accounting terms, the left side of an account is referred to as the **debit** side. The right side of an account is referred to as the **credit** side. An example of a **T-account** is below:

Account Title	
Debit = left side Dr.	Credit = right side Cr.

Although T-accounts are not an official accounting tool, accounting professors use them to help students visualize the accounts. When first learning accounting, it can be very confusing trying to understand why some accounts are increased with debits (on the left side) whereas other accounts are increased with credits (on the right side). However confusing this might be, it was designed this way for a purpose. In addition to the rule that states that assets must always equal liabilities plus stockholders' equity, another accounting rule states that in every transaction, the dollar amount of debits must equal the dollar amount of credits. By requiring that the amount of debits always equals the amount of credits, and by having some accounts increase with debits and other accounts increase with credits, the accounting equation is automatically kept in balance. **Exhibit 2-1** shows the accounting equation with T-accounts under each type of account, along with which side of the account increases it or decreases it.

When trying to learn which accounts are increased with debits and which accounts are increased with credits, it is helpful to think of the acronym ADE and the acronym LCR. In the acronym ADE, the A stands for Assets, the D for Dividends, and the E for Expenses. These accounts are increased on the debit side (think of the DE in ADE). In the acronym LCR, the L stands for Liabilities, the C stands for Common Stock, and the R stands for both Revenues and Retained Earnings. These accounts are increased on the credit side (think of the CR in LCR).

Exhibit2-1



Accounting in Your World

Jill recently purchased something over the phone and used her debit card to pay for it. When she checked her bank account activity online, the bank "debited" her account when it took money out of her account to pay for the purchase. Jill read in the textbook that a debit would increase her cash account. Now Jill is really confused.

= Debit = ?

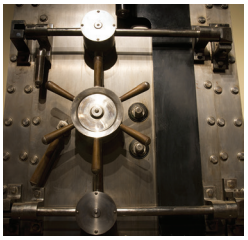
Many students feel this way when first introduced to debits and credits. It is really just a matter of perspective. You see, your bank account is an asset to you because it represents cash that is yours. However, your account is a liability to the bank because it represents money that the bank owes you. So, when the bank removes money from your account, it debits the account to lower the liability because it no longer owes you the money. This is why it is called a debit card. You would actually need to credit your cash account, an asset, to show a decrease to your cash. Because you view your account as an asset and the bank views it as a liability, what you do (debit or credit) to the account to increase or decrease it will be exactly opposite of what the bank does.

You

Asset

Your Account

Liability



Bank

Normal Balance

Normal balance The balance that appears on the side of an account where increases are recorded; the expected balance of an account.

You would expect an account to have a positive balance; therefore, the **normal balance** of an account is on the increase side of an account:

- Assets increase on the debit side, so the normal balance of an asset is on the debit side.
- Liabilities increase on the credit side, so the normal balance of a liability is on the credit side.
- Common Stock increases on the credit side, so the normal balance of this account is on the credit side.
- Retained Earnings increases on the credit side, so the normal balance of this account is on the credit side.
- Dividends increase on the debit side, so the normal balance of the Dividends account is on the debit side.
- Revenues increase on the credit side, so the normal balance of a revenue is on the credit side.
- Expenses increase on the debit side, so the normal balance of an expense is on the debit side.

How Are the General Journal and General Ledger Used to Keep Track of Business Transactions?

3 **Demonstrate the use of the general journal and the general ledger to record business transactions**

General journal The chronological accounting record of the transactions of a business.

Record Entering a transaction in a journal; also called **journalizing**.

Transaction An event that has a financial impact on a business entity.

Although it would be possible to enter transactions directly into the T-accounts, if we were to try to do this for a real company, it would become very cumbersome and inefficient. Accountants need to enter transactions efficiently and in a timely manner. To do this, the **general journal** was created. The general journal is a chronological, or date order, record of the transactions of a business. The general journal can be compared to an individual person's diary. Like a diary, the general journal is a place to **record** events that have affected the business. Recording a **transaction** in the general journal is referred to as **journalizing** the transaction. To record a journal entry:

1. Record the date.
2. Record the debit part of the entry by entering the account title and then entering the amount in the debit column.
3. Record the credit part of the entry on the next line by indenting the account title and then entering the amount in the credit column.
4. Write an explanation describing the entry.

Exhibit 2-2, Panel A, describes a transaction, and Panel B shows how this transaction is entered in the journal. The page number of the journal appears in its upper-right corner.

General ledger The accounting record summarizing, in accounts, the transactions of a business and showing the resulting ending account balances.

Posting Copying information from the general journal to accounts in the general ledger.

Because the information in the general journal is organized by date and not by account, the information it provides is not very useful. To be more useful, information must be organized by account. Therefore, the **general ledger** was created. The general ledger is a grouping of all the accounts of a business with their balances. It shows the amounts of Assets, Liabilities, and the Stockholders' Equity accounts on a given date. Once transactions have been entered in the general journal, the information is then transferred to the general ledger. The process of transferring information from the general journal to the general ledger is called **posting**. Posting simply means copying the amounts from the journal to the ledger. Debits in the journal are posted as debits in the ledger, and credits in the journal are posted as credits in the ledger. Exhibit 2-2, Panel C, demonstrates how an entry is posted from the journal to the ledger.

The posting process demonstrated in Exhibit 2-2 includes four steps. The four steps required to post the first part of the journal entry are as follows:

Posting reference A notation in the journal and ledger that links the two accounting records together.

Arrow 1 Copy the transaction date from the journal to the Cash account in the ledger.

Arrow 2 Copy the journal page number from the journal to the **posting reference** column in the Cash account in the ledger. "J.1" refers to Journal page 1. This provides a reference that links the entry in the ledger back to the journal.

Arrow 3 Copy the dollar amount of the debit, $10,000, from the journal as a debit into the Cash account in the ledger.

Arrow 4 Copy the account number, 111, from the Cash account in the ledger back to the posting reference column in the journal. This step indicates that the $10,000 debit to Cash was posted to the Cash account in the ledger.

The journal entry is posted to Cash first because this is the first account listed in the entry. Once posting to Cash is complete, repeat the process to post the entry to Common Stock. The account format used in Panel C of Exhibit 2-2 is called a four-column account. The first pair of debit and credit columns contains the individual transaction amounts that have been posted from journal entries, such as the $10,000 debit. The second pair of debit and credit columns is used to show the account's balance after each entry. Posting used to occur on a periodic basis, such as daily or weekly. However, most modern computerized accounting systems post transactions immediately after they have been entered.

Exhibit 2-2

PANEL A—Illustrative Transaction:

DATE	TRANSACTION
Jan 1, 2018	Bold City Consulting, Inc., sold $10,000 of common stock to Brian Miller, who was investing cash in the business.

PANEL B—Journal:

Page 1

DATE	ACCOUNTS		POST REF.	DR.	CR.
Jan 1, 2018	Cash		111	10,000	
	Common Stock		311		10,000
	Sold stock.				

PANEL C—Ledger:

Cash — Account No. 111

DATE	ITEM	POST REF.	DEBIT	CREDIT	BALANCE DEBIT	BALANCE CREDIT
2018 Jan 1		J.1	10,000		10,000	

Common Stock — Account No. 311

DATE	ITEM	POST REF.	DEBIT	CREDIT	BALANCE DEBIT	BALANCE CREDIT
2018 Jan 1		J.1		10,000		10,000

Transaction Analysis

To properly record, or journalize, transactions in the general journal, it is helpful to complete a five-step process. Steps 1 through 4 analyze the transaction for the journal entry, and step 5 reflects the journalizing of the transaction and the posting from the journal into the accounts in the general ledger.

Step 1 What accounts are involved? *Example*: Cash, Accounts Payable, Salaries Expense, etc.

Step 2 For each account involved, what type of account is it? Is it an asset, a liability, or one of the stockholders' equity accounts? *Example*: Cash is an asset.

Step 3 Is the account balance increasing or decreasing? *Example*: If you receive cash, then that account increases.

Step 4 Should the account be debited or credited? *Example*: Cash is an asset and it increases; increases in assets are recorded as debits.

Step 5 Record the entry and post to the accounts in the general ledger.

The five-step analysis looks like the following in chart form:

Step 1	Step 2	Step 3	Step 4	Step 5
Accounts affected	Type	↑↓	Dr. or Cr.	Journalize entry and post to ledger

Applying Transaction Analysis

Check out how the transactions for the first month of operations for Bold City Consulting, Inc., are analyzed and recorded. These transactions were examined in Chapter 1 for a new consulting business. Note that for illustration purposes, journal entries are shown

being posted to T-accounts within the accounting equation. In actual practice, the journal entries would be posted to four-column accounts in the general ledger.

1. **Sale of stock.** The business sold Brian Miller $10,000 of common stock for cash.

Analysis of Transaction (1)

Step 1 What accounts are involved? The business received cash in exchange for stock, so the accounts involved are Cash and Common Stock.

Step 2 What type of account is it? Cash is an asset. Common Stock is an account within stockholders' equity.

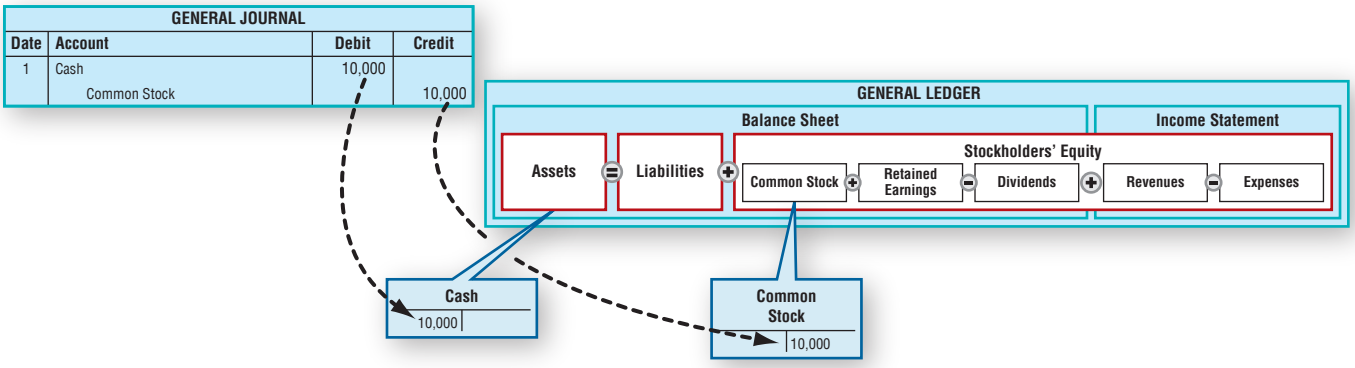
Step 3 Does the account balance increase or decrease? Because cash was received, Cash is increased. Common Stock also increases because more stock has been issued.

Step 4 Do you debit or credit the account in the journal entry? According to the rules of debits and credits, an increase in an asset is recorded with a debit. An increase in Common Stock is recorded with a credit.

The first four steps can be summarized as follows:

1	2	3	4
Accounts Affected	**Type**	**↑↓**	**Dr. or Cr.**
Cash	Asset	↑	Dr.
Common Stock	Stockholders' Equity	↑	Cr.

Step 5 Journalize and post the transaction as follows:



Notice that the name of the account being credited is indented in the journal. This format is a standard way to differentiate the accounts that are credited from the accounts that are debited. Also, note again that every transaction affects at least two accounts and that the total amount added to the debit side equals the total amount added to the credit side. This demonstrates double-entry accounting, which keeps the accounting equation in balance.

2. **Purchase supplies on credit.** Bold City Consulting purchases office supplies, agreeing to pay $250 within 30 days.

Analysis of Transaction (2)

Step 1 The business received supplies in exchange for a promise to pay cash to the supplier next month. The accounts involved in the transaction are Supplies and Accounts Payable.

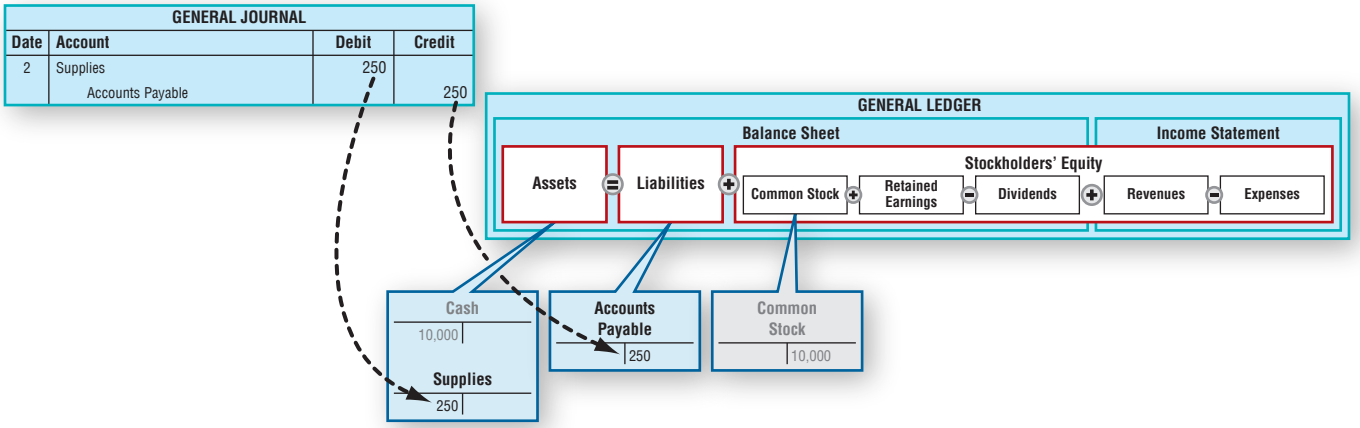
Step 2 Supplies is an asset; Accounts Payable is a liability.

Step 3 The asset Supplies is increased. The liability Accounts Payable is increased because the business owes more than it did before this transaction.

Step 4 An increase in the asset Supplies is a debit; an increase in the liability Accounts Payable is a credit.

1	2	3	4
Accounts Affected	**Type**	**↑↓**	**Dr. or Cr.**
Supplies	Asset	↑	Dr.
Accounts Payable	Liability	↑	Cr.

Step 5 Journalize and post the transaction:



3. **Purchase equipment for cash.** The business purchases equipment, paying cash of $1,400.

Analysis of Transaction (3)

Step 1 The business received equipment in exchange for cash paid to the equipment manufacturing company. The accounts involved in the transaction are Equipment and Cash.

Step 2 Equipment and Cash are both assets.

Step 3 The asset Equipment is increased. The asset Cash is decreased because a check was written to pay for the equipment.

Step 4 An increase in the asset Equipment is a debit; a decrease in the asset Cash is a credit.

1	2	3	4
Accounts Affected	**Type**	**↑↓**	**Dr. or Cr.**
Equipment	Asset	↑	Dr.
Cash	Asset	↓	Cr.