

CHAPTER 1

ACCOUNTING IN ACTION

Objectives: After studying this chapter, you should be able to:

- . Explain what accounting is
 - . Identify the users and uses of accounting
 - . Explain accounting standards and measurement principles
 - . Explain the monetary unit assumption and economic unit assumption
 - . State the accounting equation and define its components
 - . Analyze the effects of business transactions on the accounting equation
 - . Understand the four financial statements and how they are prepared
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To acquire the skills needed to understand what is happening financially inside a company we choose accounting. In order to understand an organization of any type, you need to know numbers.

What is Accounting?

The purpose of accounting is to:

- Identify,
- Record, and
- Communicate the economic ***events** of an organization to interested users.

*Examples of events: Sale of food and beverage, Manufacture of motor vehicles, service provided by insurance companies.

Who Uses Accounting Data?

Internal Users: The managers within the organization who plan, organize and run the business are the internal users of accounting information. These include marketing managers, production supervisors, finance directors, and company officers.

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

- Investors use accounting information to make decisions to buy, hold or sell ownership shares of a company.
- Creditors such as suppliers and bankers use accounting information to evaluate the risks of granting credit or lending money.

Accounting Standards

To make sure that financial reporting is of high quality, accountants present financial statements in conformity with accounting standards that are issued by standard setting bodies. Currently, there are two primary accounting standard setting bodies-

- The International Accounting Standards Board (IASB) <http://www.iasb.org/>
- The Financial Accounting Standards Board (FASB) <http://www.fasb.org/> .

- More than 130 countries follow standards referred to as **International Financial Reporting Standards** (IFRS). IFRSs are determined by the IASB.
- Most companies in the United States follow standards issued by the FASB, referred to as **Generally Accepted Accounting Principles** (GAAP).

Measurement Principles

Cost Principle (Historical) – The historical cost principle dictates that companies record assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held.

Fair Value Principle – The fair value principle states that assets and liabilities should be reported at fair value. Fair value information may be more useful than historical cost for certain type of assets and liabilities. For example, certain investment securities are reported at fair value because market value information is usually readily available for these types of assets.

Assumptions:

Assumptions give adequate foundation for the accounting process. Two main assumptions are the monetary unit assumption and the economic entity assumption.

Monetary Unit Assumption – Only transaction data's that can be expressed in terms of money should be included in the accounting records.

Economic Entity Assumption – holds that the entities activities needs to be kept separate and distinct from the activities of its owner and other economic entities.

Forms of Business Ownership:

Proprietorship

- Generally owned by one person.
- Often small service-type businesses
- Owner receives any profits, suffers any losses, and is personally liable for all debts.

Partnership

- Owned by two or more persons.
- Often retail and service-type businesses
- Generally unlimited personal liability
- Partnership agreement

Corporation

- Ownership divided into shares
- Separate legal entity organized under state corporation law
- Limited liability

The Basic Accounting Equation

The two basic elements of a business are *what it owns* and *what it owes*.

Assets are the resources a business owns.

Liabilities and owner's equity are the rights or claims against these resources.

Claims of owners are called equity.

$ASSETS = LIABILITIES + EQUITY$

This relationship is the basic accounting equation.

Assets

- Resources a business owns.
- Provide future services or benefits.
- Cash, Inventory, Equipment, etc.

Assets are classified into Current Assets and Non-current Assets.

(1) Current Assets:

Current Assets are resources that are expected to be consumed in the business within one year.

They are:

Cash
Short-term investments or Marketable Securities
Accounts Receivable
Notes Receivable
Inventory
Supplies
Prepaid expenses

Cash- includes currency, and checks.

Short-term investments- are shares or bonds which can be easily bought or sold in the stock exchange.

Accounts Receivable- arises from credit sales. The debtor or customer agrees (a verbal promise) to make payment within a certain period of time but no interest is charged.

Notes Receivable -are written promissory notes (written promise) from the debtor or customer whereby the customer promises to make payment after a certain period of time. *An interest rate is applied on these notes.*

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Inventories- include merchandise and raw materials used in production

Supplies- These are materials acquired for use in the office such as paper and stationery.

Prepaid expense -These are expenses which are paid in advance and for which no service has yet been performed to the business. Ex: Prepaid Rent, Prepaid insurance

(2) Non-Current assets:

Non-current assets are tangible resources that are used in the business for a long period and not intended for sale. They are also called Plant Assets / Property, Plant and Equipment. They are:

- Land
- Building
- Equipment

Liabilities are existing debts and obligations of the business.

Liabilities are classified into Current Liabilities and Non-current Liabilities.

1) Current Liabilities.

Current Liabilities are obligations that are expected to be paid within one year. They are:

- Notes Payable
- Accounts Payable
- Unearned Revenue
- Salaries and wages Payable
- Other short-term payables.

Notes Payable is a *promissory note made and signed by the business, (written promise)* whereby the business promises to make payment after a certain period of time. Interest is payable on the note.

Accounts Payable arises from *credit purchases (oral promise)*. The business agrees to make the payment after a certain period of time. No interest is payable.

Unearned Revenue is an advance received by the business from the customer but services will be rendered only in the future.

Other Payables are expenses due but not yet paid and has to be paid in the future.

2) Non- Current Liabilities:

Non-current liabilities are obligations expected to be paid after one year.

Examples:

- Mortgage Payable- Pay a loan that is secured by a property.
- Bank loan – an amount of money loaned at interest by a bank to a borrower.
- Bonds Payable- is a form of long-term debt issued by corporations, government etc. Bond carries interest.

Shareholders' Equity (Residual equity)

The ownership claim on total assets is equity. It is equal to total assets minus total liabilities.

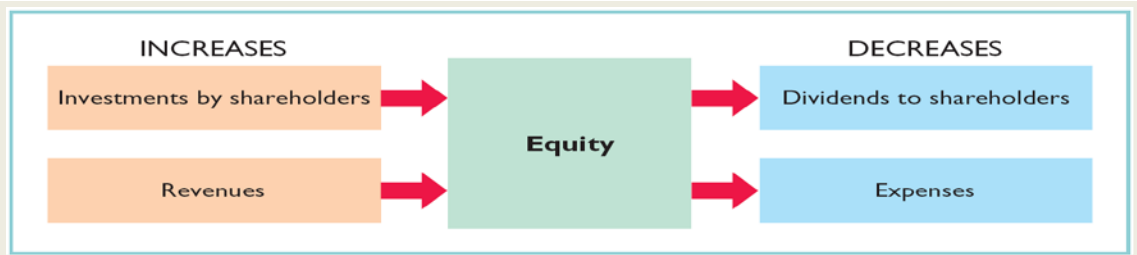
Equity generally consists of (1) **share capital- ordinary and (2) retained earnings.**

Share Capital-Ordinary:

Share Capital-Ordinary is the term used to describe the amounts paid in by shareholders for the ordinary shares they purchase. (investment made by shareholders).

Retained Earnings:

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



Revenues result from business activities entered into for the purpose of earning income. Generally results from selling merchandise, performing services, renting property, and lending money.

Expenses are the cost of assets consumed or services used in the process of earning revenue. Common expenses are salaries expense, rent expense, utilities expense, tax expense, etc.

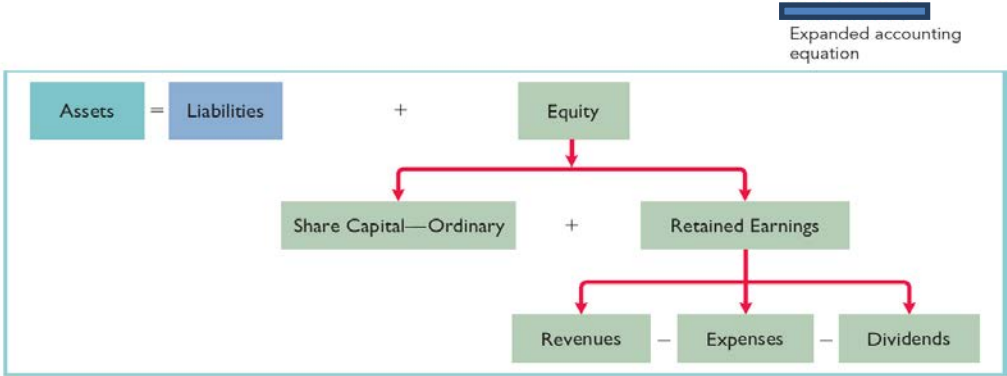
Dividends are the distribution of cash or other assets to shareholders. It reduces retained earnings but it is not an expense.

USING THE ACCOUNTING EQUATION:

Transactions are a business’s economic events *recorded* by accountants.

- May be external or internal.
- Not all activities represent transactions.
- Each transaction has a **dual effect** on the accounting equation.

TRANSACTION ANALYSIS



Transaction (1). Investment by Shareholders. Alex and Amy decide to open a computer programming service which they name Betagun. On September 1, they invest \$15,000 cash in exchange for capital shares. The effect of this transaction on the basic equation is:

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

Transaction (2). Purchase of equipment for cash \$7,000.

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

Transaction (3). Purchase of Supplies on Credit. Betagun purchased computer paper and other supplies on account for \$1,600 from Elon Supply Company. The supplies are expected to last several months.

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

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Transaction (4). Services Provided for Cash. Betagun receives \$1,200 cash from customers for programming services it has provided.

	Assets				=	Liabilities	+	Equity							
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings				
											Rev.	-	Exp.	-	Div.
Old Bal.	\$8,000		\$1,600		\$7,000	=	\$1,600		\$15,000						
(4)	+1,200										+1,200				
New Bal.	\$9,200	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$1,200				
	\$17,800						\$17,800								

Transaction (5). Purchase of Advertising on Credit. Betagun receives a bill for \$250 from the Sundry News for advertising but postpones payment until a later date.

		Assets				=	Liabilities	+	Equity							
		Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Retained Earnings				
												Rev.	-	Exp.	-	Div.
(5)	Old Bal.	\$9,200		\$1,600		\$7,000	=	\$1,600		\$15,000		\$1,200				
								+ 250						- \$250		
	New Bal.	\$9,200	+	\$1,600	+	\$7,000	=	\$1,850	+	\$15,000	+	\$1,200	-	\$250		
		\$17,800						\$17,800								

Transaction (6). Services Provided for Cash and Credit. Betagun provides \$3,500 of programming services for customers. The company receives cash of \$1,500 from customers, and it bills the balance of \$2,000 on account.

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

Transaction (7). Payment of Expenses. Betagun pays the following Expenses in cash for September: store rent \$600, salaries of employees \$900, and utilities \$200.

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

Transaction (8). Payment of Accounts Payable. Betagun pays its \$250 Sundry News bill in cash.

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

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Transaction (9). Receipt of Cash on Account. Betagun receives \$600 in cash from customers who had been billed for services [in Transaction (6)].

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

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(2) **Betagun Inc.**
Retained Earnings Statement
For the Month Ended September 30, 20XX

Retained earnings, September 1	\$ 0
Add: Net Income	<u>2,750</u>
	2,750
Less: Dividends	<u>1,300</u>
Retained earnings, September 30	<u><u>\$1,450</u></u>

(3) **Betagun Inc.**
Statement of Financial Position
September 30, 20XX
Assets

<u>Current Assets:</u>		
Cash	\$8,050	
Accounts receivable	1,400	
Supplies	<u>1,600</u>	
Total Current Assets		\$11,050
<u>Non-Current Assets:</u>		
Property, Plant and Equipment:		
Equipment		<u>7,000</u>
Total Assets		<u><u>\$18,050</u></u>
<u>Liabilities and Shareholder's Equity</u>		
<u>Liabilities:</u>		
<u>Current Liabilities:</u>		
Accounts payable		\$1,600
<u>Shareholders' Equity:</u>		
Share Capital- ordinary	\$ 15,000	
Retained earnings, September 30	<u>1,450</u>	<u>16,450</u>
Total Liabilities and Shareholder's equity		<u><u>\$18,050</u></u>

FORMAT OF STATEMENT OF FINANCIAL POSITION
ASSETS

<u>Current Assets:</u>			
Cash		9,000	
Marketable securities		200	
Accounts receivable		4,800	
Notes receivable		5,000	
Inventory		200	
Supplies		1,800	
Prepaid expense		<u>1,400</u>	
Total Current Assets			22,400
<u>Non-Current Assets:</u>			
Property, Plant and Equipment:			
Land		\$11,500	
Building	15,000		
Less: Accumulated Depreciation-Building	<u>1,000</u>	14,000	
Equipment	7,500		
Less: Accumulated Depreciation-Equipment	<u>500</u>	7,000	
Total Property Plant and Equipment		\$32,500	
Intangible Assets			...0....
Total Non-current Assets			<u>\$32,500</u>
Total Assets			<u>\$54,900</u>

LIABILITIES AND SHAREHOLDERS' EQUITY
LIABILITIES

<u>Current Liabilities:</u>			
Notes Payable	4,000		
Accounts Payable	3,000		
Interest Payable	500		
Salaries and Wages Payable	800		
Unearned Revenue	<u>1,000</u>		
Total Current Liabilities		9,300	
<u>Non-current Liabilities:</u>			
Mortgage Payable	12,000		
Bank Loan	7,000		
Bonds Payable	<u>3,000</u>		
Total Non-current liabilities		<u>22,000</u>	
Total Liabilities			31,300
<u>Shareholders' equity:</u>			
Share Capital-Ordinary shares	\$15,000		
Retained Earnings	<u>8,600</u>		
Total Shareholders' Equity			<u>23,600</u>
Total Liabilities and Shareholders' equity			<u>\$54,900</u>

PROBLEMS

Problem 1:

Homans Repair LTD was started on May 1, 20XX. A summary of May transactions is presented below:

- 1. Shareholders invested \$10,000 cash in the business in exchange for ordinary shares.
- 2. Purchased equipment for \$5,000 cash.
- 3. Paid \$400 cash for May office rent.
- 4. Paid \$500 cash for supplies.
- 5. Incurred \$250 of advertising costs in The Beacon News on account.
- 6. Received \$4,700 in cash from customers for repair service.
- 7. Declared and paid \$1,000 cash dividends.
- 8. Paid part time employee salaries \$1,000.
- 9. Paid utility bills \$140.
- 10. Provided repair service on account to customers \$980.
- 11. Collected cash of \$120 for services billed in transaction (10).

Instructions: Prepare a tabular analysis of the transactions based on the accounting equation. The accounts to be used are Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Share Capital and Retained Earnings.

	Cash +	A/R +	Supplies+	Equipment =	A/P +	Share Capital+	Retained Earnings	Remarks

Problem: 2

On August 31, 20XX, the statement of financial position of Nash Veterinary Clinic showed Cash \$9,000, Accounts Receivable \$1,700, Supplies \$600, Equipment \$6,000, Accounts Payable \$3,600, Share Capital-Ordinary \$13,000, and Retained Earnings \$700. During September, the following transactions occurred.

- 1. Paid \$2,900 cash for accounts payable due.
- 2. Collected \$1,300 of accounts receivable.
- 3. Purchased additional equipment for \$2,100, paying \$800 in cash and the balance on account.
- 4. Earned revenue of \$7,300, of which \$2,500 is collected in cash and the balance is due in October.
- 5. Declared and paid a \$400 cash dividend.
- 6. Paid salaries \$1,700, rent for September \$900, and advertising expense \$200.
- 7. Incurred utilities expense for month on account \$170.
- 8. Received \$10,000 from Capital Bank on a 6-month note payable.

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Instructions:

- (a) Prepare a tabular analysis of the September transactions beginning with August 31 balances. The column headings should be as follows; Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Share Capital + Retained Earnings.
- (b) Prepare an income statement for September, a retained earnings statement for September and a statement of financial position at September30, 20XX.

a)

Date	Cash +	A/R +	Supplies+	Equip =	N/P +	A/P +	Share + Capital	Retained Earnings	Remarks

b) Income statement

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Retained earnings statement

[illegible]

Statement of Financial Position

[illegible]

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Problem: 3

Riyo started a delivery service, Riyo Deliveries, on June 1, 20XX. The following transactions occurred during the month of June.

- June 1 Shareholders invested \$10,000 cash in the business in exchange for ordinary shares.
- 2 Purchased a delivery equipment for deliveries for \$14,000. Riyo paid \$2,000 cash and signed a note payable for the remaining balance.
- 3 Paid \$500 for office rent for the month.
- 5 Performed \$4,800 of services on account.
- 9 Declared and paid \$300 in cash dividends.
- 12 Purchased supplies for \$150 on account.
- 15 Received a cash payment of \$1,250 for services provided on June 5.
- 17 Incurred gasoline expense for the month on account \$100.
- 20 Received a cash payment of \$1,500 for services provided.
- 23 Made a cash payment of \$500 on the note payable.
- 26 Paid \$250 for utilities.
- 29 Paid for the gasoline expense incurred on account on June 17.
- 30 Paid \$1,000 for employee salaries.

Instructions:

- (a) Show the effects of the transactions on the accounting equation.
- (b) Prepare an income statement for the month of June, 20XX.
- (c) Prepare a statement of financial position at June 30, 20XX.

a)

Date	Cash +	A/R +	Supplies+	Del:Equip=	N/P +	A/P +	Share + Capital	Retained Earnings	Remarks

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b) Income Statement[illegible]

c) Statement of Financial Position

[illegible]
