

The Company's First Transaction McBryan officially started Overnight on January 20, 2011. On that day, he received a charter from the state to begin a small, closely held corporation whose owners consisted of himself and several family members. Capital stock issued to

these investors included 8,000 shares at \$10 per share. McBryan opened a bank account in the name of Overnight Auto Service, into which he deposited the \$80,000 received from the issuance of the capital stock.

This transaction provided Overnight with its first asset—Cash—and also created the initial owners' equity in the business entity. See the balance sheet showing the company's financial position after this initial transaction in Exhibit 2–2.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 20, 2011			
Assets		Owners' Equity	
Cash	<u>\$80,000</u>	Capital Stock	<u>\$80,000</u>

Overnight's next two transactions involved the acquisition of a suitable site for its business operations.

Purchase of an Asset for Cash Representing the business, McBryan negotiated with both the City of Santa Teresa and the Metropolitan Transit Authority (MTA) to purchase an abandoned bus garage. (The MTA owned the garage, but the city owned the land.)

On January 21, Overnight purchased the land from the city for \$52,000 *cash*. This transaction had two immediate effects on the company's financial position: first, Overnight's cash

was reduced by \$52,000; and second, the company acquired a new asset—Land. We show the company's financial position after this transaction in Exhibit 2–3.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 21, 2011			
Assets		Owners' Equity	
Cash	\$28,000	Capital Stock	\$80,000
Land	52,000		
Total	<u>\$80,000</u>	Total	<u>\$80,000</u>

Purchase of an Asset and Financing Part of the Cost On January 22, Overnight purchased the old garage building from Metropolitan Transit Authority for \$36,000. Overnight made a cash down payment of \$6,000 and issued a 90-day non-interest-bearing note payable for the \$30,000 balance owed.

As a result of this transaction, Overnight had (1) \$6,000 less cash; (2) a new asset, Building, which cost \$36,000; and (3) a new liability, Notes Payable, in the amount of \$30,000. This transaction is reflected in Exhibit 2–4.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 22, 2011			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,000	Liabilities:	
Land	52,000	Notes Payable	\$ 30,000
Building	36,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$110,000</u>	Total	<u>\$110,000</u>

Purchase of an Asset on Account On January 23, Overnight purchased tools and automotive repair equipment from Snappy Tools. The purchase price was \$13,800, due within 60 days. After this purchase, Overnight's financial position is depicted in Exhibit 2–5.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 23, 2011			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,000	Liabilities:	
Land	52,000	Notes Payable	\$ 30,000
Building	36,000	Accounts Payable	13,800
Tools and Equipment	13,800	Total liabilities	\$ 43,800
		Owners' equity:	
		Capital Stock	80,000
Total	<u>\$123,800</u>	Total	<u>\$123,800</u>

Activate Window

Sale of an Asset After taking delivery of the new tools and equipment, Overnight found that it had purchased more than it needed. Ace Towing, a neighboring business, offered to buy the excess items. On January 24, Overnight sold some of its new tools to Ace for \$1,800, a price equal to Overnight's cost.² Ace made no down payment but agreed to pay the amount due within 45 days. This transaction reduced Overnight's tools and equipment by \$1,800 and created a new asset, Accounts Receivable, for that same amount. A balance sheet as of January 24 appears in Exhibit 2–6.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 24, 2011			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,000	Liabilities:	
Accounts Receivable	1,800	Notes Payable	\$ 30,000
Land	52,000	Accounts Payable	13,800
Building	36,000	Total liabilities	\$ 43,800
Tools and Equipment	12,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$123,800</u>	Total	<u>\$123,800</u>

Collection of an Account Receivable On January 26, Overnight received \$600 from Ace Towing as partial settlement of its account receivable from Ace. This transaction caused an increase in Overnight's cash but a decrease of the same amount in accounts receivable. This transaction converts one asset into another of equal value; there is no change in the

amount of total assets. After this transaction, Overnight's financial position is summarized in Exhibit 2-7.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 26, 2011			
Assets		Liabilities & Owners' Equity	
Cash	\$ 22,600	Liabilities:	
Accounts Receivable	1,200	Notes Payable	\$ 30,000
Land	52,000	Accounts Payable	13,800
Building	36,000	Total liabilities	\$ 43,800
Tools and Equipment	12,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$123,800</u>	Total	<u>\$123,800</u>

Payment of a Liability On January 27, Overnight made a partial payment of \$6,800 on its account payable to Snappy Tools. This transaction reduced Overnight's cash and accounts payable by the same amount, leaving total assets and the total of liabilities plus owners' equity in balance. Overnight's balance sheet at January 27 appears in Exhibit 2-8.

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 27, 2011			
Assets		Liabilities & Owners' Equity	
Cash	\$ 15,800	Liabilities:	
Accounts Receivable	1,200	Notes Payable	\$ 30,000
Land	52,000	Accounts Payable	7,000
Building	36,000	Total liabilities	\$ 37,000
Tools and Equipment	12,000	Owners' equity:	
		Capital Stock	80,000
Total	<u>\$117,000</u>	Total	<u>\$117,000</u>

Earning of Revenue By the last week in January, McBryan had acquired the assets Overnight needed to start operating, and he began to provide repair services for customers. Rather than recording each individual sale of repair services, he decided to accumulate them and record them at the end of the month. Sales of repair services for the last week of January were \$2,200, all of which was received in cash.

Earning of revenue represents the creation of value by Overnight. It also represents an increase in the financial interest of the owners in the company. As a result, cash is increased by \$2,200 and owners' equity is increased by the same amount. To distinguish owners' equity that is earned from that which was originally invested by the owners, the account *Retained Earnings* is used in the owners' equity section of the balance sheet. The balance sheet in Exhibit 2–9, as of January 31, reflects the increase in assets (cash) and owners' equity (retained earnings) from the revenue earned and received in cash during the last week of January, but before the payment of expenses (see next section).

OVERNIGHT AUTO SERVICE BALANCE SHEET JANUARY 31, 2011					
Assets			Liabilities & Owners' Equity		
Cash	\$	18,000	Liabilities:		
Accounts Receivable ...		1,200	Notes Payable	\$	30,000
Land		52,000	Accounts Payable		7,000
Building		36,000	Total liabilities		\$ 37,000
Tools and Equipment ...		12,000	Owners' equity:		
			Capital Stock	\$	80,000
			Retained Earnings ...		2,200
Total		<u>\$119,200</u>	Total		<u>\$119,200</u>

Payment of Expenses In order to earn the \$2,200 of revenue that we have just recorded, Overnight had to pay some operating expenses, namely utilities and wages. McBryan decided to pay all operating expenses at the end of the month. For January, he owed \$200 for utilities and \$1,200 for wages to his employees, a total of \$1,400, which he paid on January 31. Paying expenses has an opposite effect from revenues on the owners' interest in the company—their investment is reduced. Of course, paying expenses also results in a decrease of cash.

The January 31 balance sheet, after the payment of utilities and wages, is presented in Exhibit 2–10.

**OVERNIGHT AUTO SERVICE
BALANCE SHEET
JANUARY 31, 2011**

Assets		Liabilities & Owners' Equity	
Cash	\$ 16,600	Liabilities:	
Accounts Receivable ...	1,200	Notes Payable	\$ 30,000
Land	52,000	Accounts Payable	<u>7,000</u>
Building	36,000	Total liabilities	\$ 37,000
Tools and Equipment ...	12,000	Owners' equity:	
		Capital Stock	\$ 80,000
		Retained Earnings ...	<u>800</u>
Total	<u>\$117,800</u>	Total	<u>\$117,800</u>

Notice that the expenses of \$1,400 (\$200 for utilities and \$1,200 for wages) reduce the amount of retained earnings in the balance sheet. That balance was formerly \$2,200, representing the revenues for the last week of January. It is now \$800, representing the difference between the revenues for the last week of January and the \$1,400 of expenses that Overnight incurred during the same period of time. From this illustration we can see that revenues enhance or increase the financial interest of owners while expenses diminish or reduce the interest of owners. In a corporation, the net effect of this activity is reflected in the balance sheet as retained earnings.

Accounting 101

expenses of \$1,400 into wages of \$1,200 and utilities of \$200, we can prepare the company's income statement as shown in Exhibit 2–12.

OVERNIGHT AUTO SERVICE INCOME STATEMENT FOR THE PERIOD JANUARY 20–31, 2011		
Sales Revenues		\$2,200
Operating expenses:		
Wages	\$1,200	
Utilities	<u>200</u>	<u>1,400</u>
Net Income		<u>\$ 800</u>

Notice that the heading for the income statement refers to a *period* of time rather than a *point* in time, as was the case with the balance sheet. The income statement reports on the financial performance of the company in terms of earning revenue and incurring expenses *over a period of time* and explains, in part, how the company's financial position changed between the beginning and ending of that period.

OVERNIGHT AUTO SERVICE STATEMENT OF CASH FLOWS FOR THE PERIOD JANUARY 20–31, 2011

Cash flows from operating activities:

Cash received from revenue transactions	\$ 2,200	
Cash paid for expenses	(1,400)	
Net cash provided by operating activities		\$ 800

Cash flows from investing activities:

Purchase of land	\$(52,000)	
Purchase of building	(6,000)	
Purchase of tools	(6,800)	
Sale of tools	600	
Net cash used by investing activities		(64,200)

Cash flows from financing activities:

Sale of capital stock		80,000
Increase in cash for the period		\$16,600
Beginning cash balance, January 20, 2011		-0-
Ending cash balance, January 31, 2011		<u>\$16,600</u>

Exhibit 2-11 EXPANDED ACCOUNTING EQUATION

OVERNIGHT AUTO SERVICE EXPANDED ACCOUNTING EQUATION JANUARY 20–31, 2011

	Assets					=	Liabilities		+	Owners' Equity	
	Cash	+ Accounts Receivable	+ Land	+ Building	+ Tools and Equipment	=	Notes Payable	+ Accounts Payable	+	Capital Stock	Retained Earnings
Jan. 20	<u>\$80,000</u>					=				<u>\$80,000</u>	
Balances	\$80,000					=				\$80,000	
Jan. 21	<u>-52,000</u>		<u>+\$52,000</u>			=					
Balances	\$28,000		\$52,000			=				\$80,000	
Jan. 22	<u>-6,000</u>			<u>+\$36,000</u>		=	<u>+\$30,000</u>				
Balances	\$22,000		\$52,000	\$36,000		=	\$30,000			\$80,000	
Jan. 23					<u>+\$13,800</u>	=		<u>+\$13,800</u>			
Balances	\$22,000		\$52,000	\$36,000	\$13,800	=	\$30,000	\$13,800		\$80,000	
Jan. 24		<u>+\$1,800</u>			<u>-1,800</u>	=					
Balances	\$22,000	\$1,800	\$52,000	\$36,000	\$12,000	=	\$30,000	\$13,800		\$80,000	
Jan. 26	<u>+600</u>	<u>-600</u>				=					
Balances	\$22,600	\$1,200	\$52,000	\$36,000	\$12,000	=	\$30,000	\$13,800		\$80,000	
Jan. 27	<u>-6,800</u>					=		<u>-6,800</u>			
Balances	\$15,800	\$1,200	\$52,000	\$36,000	\$12,000	=	\$30,000	\$7,000		\$80,000	
Jan. 31	<u>+2,200</u>					=					<u>+\$2,200</u>
Jan. 31	<u>-1,400</u>					=					<u>-1,400</u>
Balances	<u>\$16,600</u>	<u>\$1,200</u>	<u>\$52,000</u>	<u>\$36,000</u>	<u>\$12,000</u>	=	<u>\$30,000</u>	<u>\$7,000</u>		<u>\$80,000</u>	<u>\$ 800</u>

Statement of Cash Flows

Income Statement