

1 Accounting in Action

Learning Objectives

- 1 Identify the activities and users associated with accounting.
- 2 Explain the building blocks of accounting: ethics, principles, and assumptions.
- 3 State the accounting equation, and define its components.
- 4 Analyze the effects of business transactions on the accounting equation.
- 5 Describe the four financial statements and how they are prepared.

1-1

LEARNING OBJECTIVE 1 Identify the activities and users associated with accounting.

Accounting consists of three basic activities—it

- identifies,
- records, and
- communicates

the economic events of an organization to interested users.

1-2 LO 1

Three Activities

Illustration 1-1
The activities of the accounting process

1-3 LO 1

Who Uses Accounting Data

INTERNAL USERS

- Marketing**: What price should **Apple** charge for an iPod to maximize the company's net income?
- Management**: Which **PepsiCo** product line is the most profitable? Should any product lines be eliminated?
- Finance**: Is cash sufficient to pay dividends to **Microsoft** stockholders?
- Human Resources**: Can **General Motors** afford to give its employees pay raises this year?

Illustration 1-2
Questions that internal users ask

1-4 LO 1

Who Uses Accounting Data

EXTERNAL USERS

- Investors**: Is **General Electric** earning satisfactory income?
- Creditors**: What do we do if they catch us? Will **United Airlines** be able to pay its debts as they come due?
- Investors**: How does **Disney** compare in size and profitability with **Time Warner**?

Illustration 1-3
Questions that external users ask

1-5 LO 1

Generally Accepted Accounting Principles

Various users need financial information

The accounting profession has developed standards that are generally accepted and universally practiced.

Financial Statements

- Balance Sheet
- Income Statement
- Statement of Owner's Equity
- Statement of Cash Flows
- Note Disclosure

Generally Accepted Accounting Principles (GAAP)

1-6 LO 2

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles (GAAP) – Standards that are generally accepted and universally practiced. These standards indicate how to report economic events.

Standard-setting bodies:

- ▶ **Financial Accounting Standards Board (FASB)**
- ▶ **Securities and Exchange Commission (SEC)**
- ▶ **International Accounting Standards Board (IASB)**

International Note
Over 100 countries use International Financial Reporting Standards (called IFRS). For example, all companies in the European Union follow international standards. The differences between U.S. and international standards are not generally significant.

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LO 2

Forms of Business Ownership

Proprietorship

- ◆ Owned by one person
- ◆ Owner is often manager/operator
- ◆ 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 of stock
- ◆ Separate legal entity organized under state corporation law
- ◆ Limited liability

1-8

LO 2

LEARNING OBJECTIVE

3

State the accounting equation, and define its components.

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

Basic Accounting Equation

- ◆ Provides the **underlying framework** for recording and summarizing economic events.
- ◆ Assets are claimed by either creditors or owners.
- ◆ If a business is liquidated, claims of creditors must be paid before ownership claims.

1-9

LO 3

Basic Accounting Equation

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

Assets

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

1-10

LO 3

Basic Accounting Equation

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

Liabilities

- ◆ Claims against assets (debts and obligations).
- ◆ Creditors (party to whom money is owed).
- ◆ Accounts Payable, Notes Payable, Salaries and Wages Payable, etc.

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LO 3

Basic Accounting Equation

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

Owner's Equity

- ◆ Ownership claim on total assets.
- ◆ Referred to as residual equity.
- ◆ Investment by owners and revenues (+)
- ◆ Drawings and expenses (-).

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LO 3

Owner's Equity

Illustration 1-6
Expanded accounting equation

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

Increases in Owner's Equity

- ◆ **Investments by owner** are the assets the owner puts into the business.
- ◆ **Revenues** result from business activities entered into for the purpose of earning income.
 - ▶ **Common sources of revenue** are: sales, fees, services, commissions, interest, dividends, royalties, and rent.

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LO 3

Owner's Equity

Illustration 1-6
Expanded accounting equation

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

Decreases in Owner's Equity

- ◆ **Drawings** An owner may withdraw cash or other assets for personal use.
- ◆ **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.

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LO 3

DO IT! 3

Owner's Equity Effects

Classify the following items as investment by owner, owner's drawings, revenue, or expenses. Then indicate whether each item increases or decreases owner's equity.

	Classification	Effect on Equity
1. Rent Expense	<input type="text"/>	<input type="text"/>
2. Service Revenue	<input type="text"/>	<input type="text"/>
3. Drawings	<input type="text"/>	<input type="text"/>
4. Salaries and Wages Expense	<input type="text"/>	<input type="text"/>

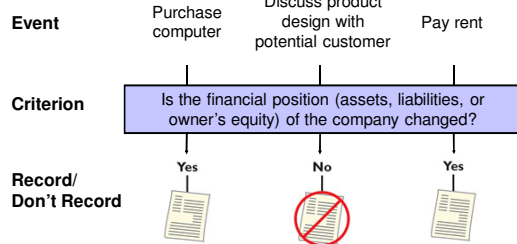
1-15

LO 3

Transaction Analysis

Illustration: Are the following events recorded in the accounting records?

Illustration 1-7



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LO 4

Transaction Analysis

TRANSACTION 1. INVESTMENT BY OWNER Ray Neal decides to start a smartphone app development company which he names Softbyte. On September 1, 2017, he invests **\$15,000 cash** in the business. This transaction results in an equal increase in assets and owner's equity.

Trans- action	Assets				= Liabilities +				Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	Exp.			
1.	+15,000					+15,000						

Illustration 1-8
Tabular summary of Softbyte transactions

1-17

LO 4

TRANSACTION 2. PURCHASE OF EQUIPMENT FOR CASH Softbyte Inc. purchases computer equipment for **\$7,000 cash**.

Illustration 1-8

Trans- action	Assets				= Liabilities +				Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	Exp.			
1.	+15,000					+15,000						
2.	-7,000			+7,000								

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LO 4

TRANSACTION 3. PURCHASE OF SUPPLIES ON CREDIT Softbyte Inc. purchases for \$1,600 headsets and other accessories expected to last several months. The supplier allows Softbyte to pay this bill in October.

Illustration 1-8

Trans- action	Assets				= Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000					+15,000				
2.	-7,000									
3.			+1,600		+1,600					

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LO 4

TRANSACTION 4. SERVICES PERFORMED FOR CASH Softbyte Inc. receives \$1,200 cash from customers for app development services it has performed.

Illustration 1-8

Trans- action	Assets				= Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000					+15,000				
2.	-7,000									
3.			+1,600		+1,600					
4.	+1,200							+1,200		

1-20

LO 4

TRANSACTION 5. PURCHASE OF ADVERTISING ON CREDIT Softbyte Inc. receives a bill for \$250 from the *Daily News* for advertising on its online website but postpones payment until a later date.

Illustration 1-8

Trans- action	Assets				= Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000					+15,000				
2.	-7,000									
3.			+1,600		+1,600					
4.	+1,200							+1,200		
5.					+250					-250

1-21

LO 4

TRANSACTION 6. SERVICES PERFORMED FOR CASH AND CREDIT. Softbyte performs \$3,500 of services. The company receives cash of \$1,500 from customers, and it bills the balance of \$2,000 on account.

Illustration 1-8

Trans- action	Assets				= Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000					+15,000				
2.	-7,000									
3.			+1,600		+1,600					
4.	+1,200							+1,200		
5.					+250					-250
6.	+1,500	+2,000						+3,500		

1-22

LO 4

TRANSACTION 7. PAYMENT OF EXPENSES Softbyte Inc. pays the following expenses in cash for September: office rent \$600, salaries and wages of employees \$900, and utilities \$200.

Illustration 1-8

Trans- action	Assets				= Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000					+15,000				
2.	-7,000									
3.			+1,600		+1,600					
4.	+1,200							+1,200		
5.					+250					-250
6.	+1,500	+2,000						+3,500		
7.	-1,700								-600	-900
									-200	

1-23

LO 4

TRANSACTION 8. PAYMENT OF ACCOUNTS PAYABLE Softbyte Inc. pays its \$250 *Daily News* bill in cash. The company previously (in Transaction 5) recorded the bill as an increase in Accounts Payable.

Illustration 1-8

Trans- action	Assets				= Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000					+15,000				
2.	-7,000									
3.			+1,600		+1,600					
4.	+1,200							+1,200		
5.					+250					-250
6.	+1,500	+2,000						+3,500		
7.	-1,700								-600	-900
									-200	
8.	-250				-250					

1-24

LO 4

TRANSACTION 9. RECEIPT OF CASH ON ACCOUNT Softbyte Inc. receives \$600 in cash from customers who had been billed for services (in Transaction 6).

Illustration 1-8

Trans- action	Assets				=	Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000						+15,000				
2.	-7,000			+7,000							
3.			+1,600			+1,600					
4.	+1,200								+1,200		
5.						+250				-250	
6.	+1,500	+2,000							+3,500		
7.	-1,700									-600	
										-900	
										-200	
8.	-250					-250					
9.	+600	-600									

1-25

LO 4

TRANSACTION 10. WITHDRAWAL OF CASH BY OWNER Ray Neal withdraws \$1,300 in cash from the business for his personal use.

Illustration 1-8

Trans- action	Assets				=	Liabilities +		Owner's Equity			
	Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.
1.	+15,000						+15,000				
2.	-7,000			+7,000							
3.			+1,600			+1,600					
4.	+1,200								+1,200		
5.						+250				-250	
6.	+1,500	+2,000							+3,500		
7.	-1,700									-600	
										-900	
										-200	
8.	-250					-250					
9.	+600	-600									
10.	-1,300								-1,300		

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\$18,050

\$18,050

LO 4

Summary of Transactions

- Each transaction is analyzed in terms of its effect on:
 - The three components of the basic accounting equation.
 - Specific of items within each component.
- The two sides of the equation must always be equal.

1-27

LO 4

DO IT! 4 Tabular Analysis

Transactions made by Virmani & Co., a public accounting firm, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1-8.

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

1-28

LO 4

DO IT! 4 Tabular Analysis

- The owner invested \$25,000 cash in the business.

Trans- action	Assets		=	Liabilities +		Owner's Equity				
	Cash	Equipment	=	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.	
1.	+25,000				+25,000					

1-29

LO 4

DO IT! 4 Tabular Analysis

- The company purchased \$7,000 of office equipment on credit.

Trans- action	Assets		=	Liabilities +		Owner's Equity				
	Cash	Equipment	=	Accounts Payable	Owner's Capital	Owner's Drawings	Rev.	-	Exp.	
1.	+25,000				+25,000					
2.		+7,000		+7,000						

1-30

LO 4

DO IT! 4 Tabular Analysis

3. The company received \$8,000 cash in exchange for services performed.

Trans- action	Assets		=	Liabilities +		Owner's Equity			
	Cash	+ Equipment	=	Accounts Payable	+ Owner's Capital	+ Owner's Drawings	+ Rev.	- Exp.	
1.	+25,000				+25,000				
2.		+7,000		+7,000					
3.	+8,000						+8,000		

1-31

LO 4

DO IT! 4 Tabular Analysis

4. The company paid \$850 for this month's rent.

Trans- action	Assets		=	Liabilities +		Owner's Equity			
	Cash	+ Equipment	=	Accounts Payable	+ Owner's Capital	+ Owner's Drawings	+ Rev.	- Exp.	
1.	+25,000				+25,000				
2.		+7,000		+7,000					
3.	+8,000						+8,000		
4.	-850							-850	

1-32

LO 4

DO IT! 4 Tabular Analysis

5. The owner withdrew \$1,000 cash for personal use.

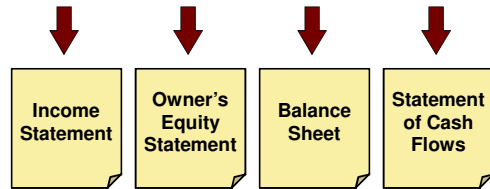
Trans- action	Assets		=	Liabilities +		Owner's Equity			
	Cash	+ Equipment	=	Accounts Payable	+ Owner's Capital	+ Owner's Drawings	+ Rev.	- Exp.	
1.	+25,000				+25,000				
2.		+7,000		+7,000					
3.	+8,000						+8,000		
4.	-850							-850	
5.	-1,000					+1,000			
	<u>\$31,150</u>	<u>+ 7,000</u>	<u>=</u>	<u>\$7,000</u>	<u>+ \$25,000</u>	<u>+ \$1,000</u>	<u>+ \$8,000</u>	<u>- \$850</u>	
	<u>\$38,150</u>			<u>\$38,150</u>					

1-33

LO 4

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

Companies prepare four financial statements :



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LO 5

Financial Statements

Net income is needed to determine the ending balance in owner's equity.

SOFTBYTE Income Statement For the Month Ended September 30, 2017		Illustration 1-9 Financial statements and their interrelationships
Revenues		
Service revenue	\$ 4,700	
Expenses		
Salaries and wages expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses	1,950	
Net income	\$ 2,750	

SOFTBYTE Owner's Equity Statement For the Month Ended September 30, 2017		Illustration 1-9 Financial statements and their interrelationships
Owner's capital, September 1	\$ -0-	
Add: Investments	\$15,000	
Net income	2,750	
	17,750	
Less: Drawings	1,300	
Owner's capital, September 30	\$16,450	

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LO 5

SOFTBYTE
Owner's Equity Statement
For the Month Ended September 30, 2017

Owner's capital, September 1		\$ -0-
Add: Investments	\$15,000	17,750
Net income	<u>2,750</u>	17,750
		1,300
Less: Drawings		1,300
Owner's capital, September 30		<u>\$16,450</u>

The ending balances in owner's equity is needed in preparing the balance sheet.

SOFTBYTE
Balance Sheet
September 30, 2017

Assets	
Cash	\$ 8,050
Accounts receivable	1,400
Supplies	1,600
Equipment	7,000
Total assets	<u>\$ 18,050</u>

Liabilities and Owner's Equity	
Liabilities	
Accounts payable	\$ 1,600
Owner's equity	
Owner's capital	<u>16,450</u>
Total liabilities and owner's equity	<u>\$ 18,050</u>

Illustration 1-9
Financial statements and their interrelationships

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Financial Statements

Balance sheet and income statement are needed to prepare statement of cash flows.

SOFTBYTE Balance Sheet September 30, 2017	
Assets	
Cash	\$ 8,050
Accounts receivable	1,400
Supplies	1,400
Equipment	7,000
Total assets	\$ 18,050
Liabilities and Owner's Equity	
Liabilities	
Accounts payable	\$ 1,400
Owner's equity	16,450
Owner's capital	\$ 18,050
Total liabilities and owner's equity	\$ 18,050

SOFTBYTE Statement of Cash Flows For the Month Ended September 30, 2017	
Cash flows from operating activities	
Cash receipts from revenues	\$ 3,300
Cash payments for expenses	(1,950)
Net cash provided by operating activities	1,350
Cash flows from investing activities	
Purchase of equipment	(7,000)
Cash flows from financing activities	
Investments by owner	\$15,000
Drawings by owner	(1,300)
Net increase in cash	8,050
Cash at the beginning of the period	0
Cash at the end of the period	\$ 8,050

Illustration 1-9
Financial statements and their interrelationships

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Income Statement

- ◆ Reports the revenues and expenses for a specific period of time.
- ◆ Lists revenues first, followed by expenses.
- ◆ Shows net income (or net loss).
- ◆ Does not include investment and withdrawal transactions between the owner and the business in measuring net income.

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

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LO 5

Owner's Equity Statement

- ◆ Reports the changes in owner's equity for a specific period of time.
- ◆ The time period is the same as that covered by the income statement.

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LO 5

Balance Sheet

- ◆ Reports the assets, liabilities, and owner's equity at a specific date.
- ◆ Lists assets at the top, followed by liabilities and owner's equity.
- ◆ Total assets must equal total liabilities and owner's equity.
- ◆ Is a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

1-40

LO 5

Statement of Cash Flows

- ◆ Information on the cash receipts and payments for a specific period of time.
- ◆ Answers the following:
 - ▶ Where did cash come from?
 - ▶ What was cash used for?
 - ▶ What was the change in the cash balance?

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LO 5

DO IT! 5 Financial Statement Items

Presented below is selected information related to Flanagan Company at December 31, 2017. Flanagan reports financial information monthly.

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

- Determine the total assets of at December 31, 2017.
- Determine the net income reported for December 2017.
- Determine the owner's equity at December 31, 2017.

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LO 5

DO IT! 5 Financial Statement Items

Presented below is selected information related to Flanagan Company at December 31, 2017. Flanagan reports financial information monthly.

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

(a) Determine the total assets of at December 31, 2017.

The total assets are \$27,000, comprised of

- Cash \$8,000,
- Accounts Receivable \$9,000, and
- Equipment \$10,000.

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LO 5

DO IT! 5 Financial Statement Items

Presented below is selected information related to Flanagan Company at December 31, 2017. Flanagan reports financial information monthly.

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

(b) Determine the net income reported for December 2017.

Revenues	
Service revenue	\$36,000
Expenses	
Rent expense	\$11,000
Salaries and wages expense	7,000
Utilities expense	4,000
Total expenses	<u>22,000</u>
Net income	<u>\$14,000</u>

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LO 5

DO IT! 5 Financial Statement Items

Presented below is selected information related to Flanagan Company at December 31, 2017. Flanagan reports financial information monthly.

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

(c) Determine the owner's equity at December 31, 2017.

Total assets [as computed in (a)]	\$27,000
Less: Liabilities	
Notes payable	\$16,500
Accounts payable	<u>2,000</u>
Owner's equity	<u>\$ 8,500</u>

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LO 5

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