

Chapter 1

Accounting in Action

CHAPTER 1

ACCOUNTING IN ACTION

After studying this chapter, you should be able to:

- 1 Explain what accounting is.
- 2 Identify users and uses of accounting.
- 3 Understand why ethics is a fundamental business concept.
- 4 Explain the meaning of generally accepted accounting principles and the cost principle.

CHAPTER 1

ACCOUNTING IN ACTION

After studying this chapter, you should be able to:

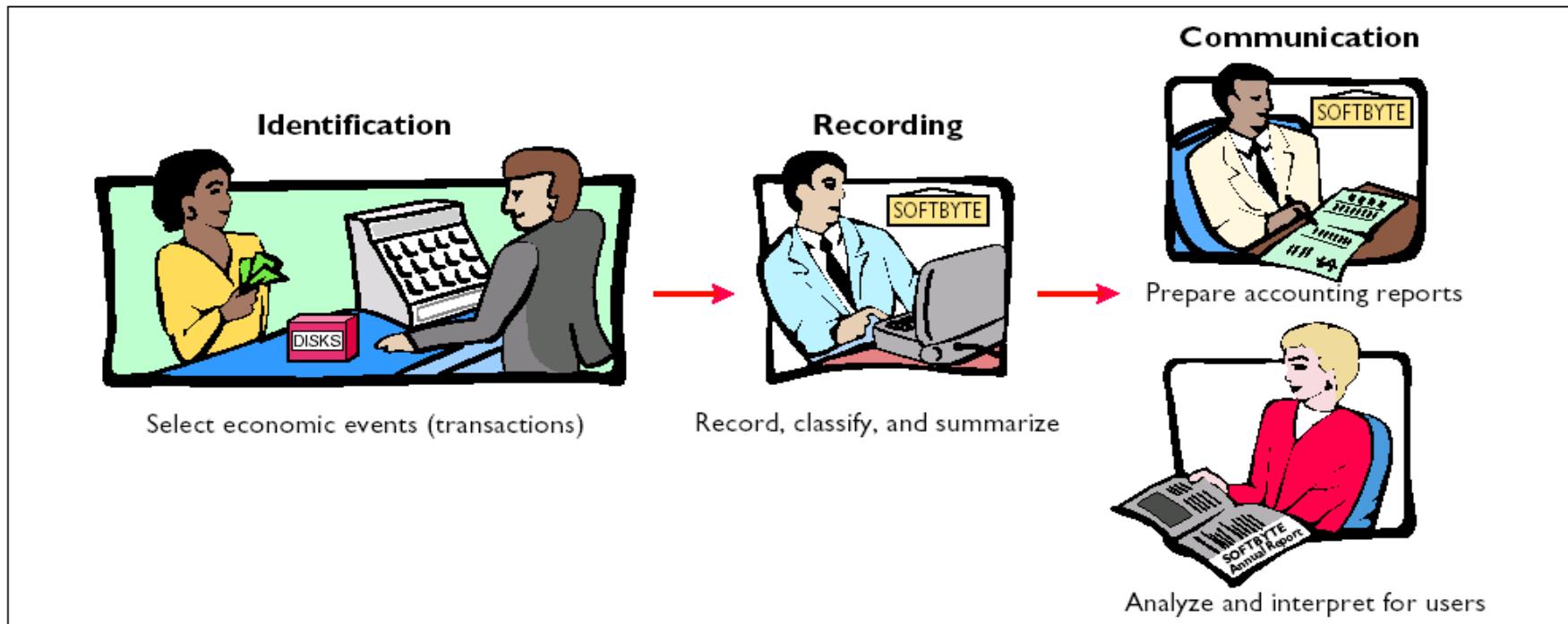
- **5 Explain the meaning of the monetary unit assumption and the economic entity assumption.**
- **6 State the basic accounting equation and explain the meaning of assets, liabilities, and owner's equity.**
- **7 Analyze the effect of business transactions on the basic accounting equation.**
- **8 Understand what the four financial statements are and how they are prepared.**

WHAT IS ACCOUNTING?

STUDY OBJECTIVE 1

- **Accounting** is an information system that
- **Identifies**
- **Records**
- **Communicates** the economic events of an organization to interested users

THE ACCOUNTING PROCESS



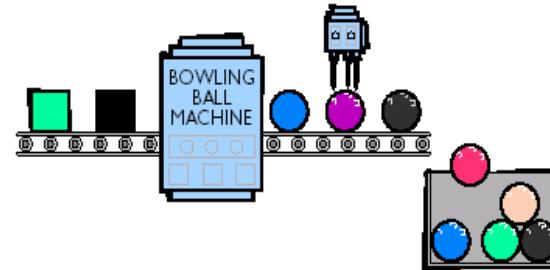
QUESTIONS ASKED BY INTERNAL USERS

STUDY OBJECTIVE 2

Questions Asked by Internal Users



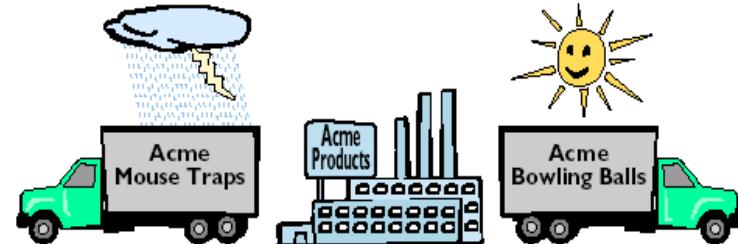
Is cash sufficient to pay bills?



What is the cost of manufacturing each unit of product?



Can we afford to give employee pay raises this year?



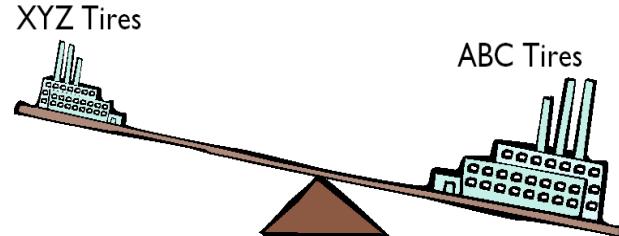
Which product line is the most profitable?

QUESTIONS ASKED BY EXTERNAL USERS

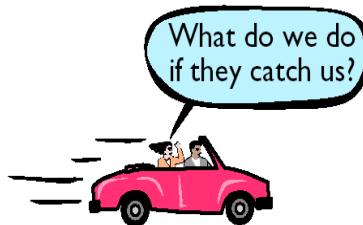
Questions Asked by External Users



Is the company earning satisfactory income?



How does the company compare in size and profitability with competitors?



Will the company be able to pay its debts as they come due?

BOOKKEEPING DISTINGUISHED FROM ACCOUNTING

- **Accounting**
Includes bookkeeping
Also includes much more
- **Bookkeeping**
The recording of economic events
One part of accounting

THE BUILDING BLOCKS OF ACCOUNTING

STUDY OBJECTIVES 3, 4 & 5

- **Ethics**
 - Standards by which actions are judged as right or wrong, honest or dishonest.
- **Generally Accepted Accounting Principles**
 - Established by the F.A.S.B and the S.E.C.
- **Assumptions**
 - Monetary Unit
 - Only data that can be expressed in terms of money is included in the accounting records.
 - Economic Entity
 - Includes any organization or unit in society.

The accounting process is correctly sequenced as

- a. identification, communication, recording.
- b. recording, communication, identification.
- c. identification, recording, communication.
- d. communication, recording, identification.

The accounting process is correctly sequenced as

- a. identification, communication, recording.
- b. recording, communication, identification.
- c. **identification, recording, communication.**
- d. communication, recording, identification.

BASIC ACCOUNTING EQUATION

STUDY OBJECTIVE 6



ASSETS AS A BUILDING BLOCK

- **Assets** are resources owned by a business.
- They are used in carrying out such activities as production, consumption and exchange.

LIABILITIES AS A BUILDING BLOCK

- **Liabilities**
 - are creditor claims against assets
 - are existing debts and obligations

OWNER'S EQUITY AS A BUILDING BLOCK

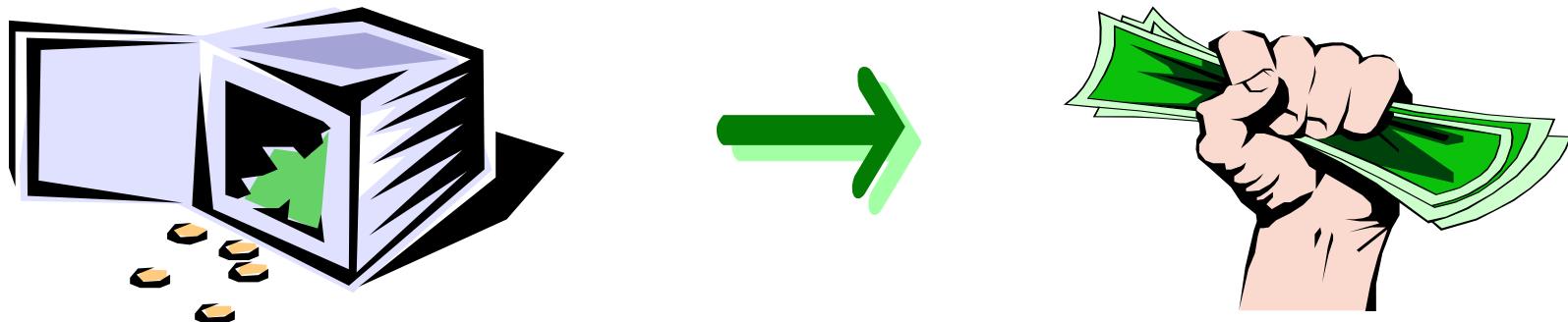
- Owner's Equity = total assets minus total liabilities. ($A - L = O.E.$)
- Owner's Equity represents the **ownership claim** to total assets.
- Subdivisions of Owner's Equity:
 - 1 Capital or Investments by Owner (+)
 - 2 Drawing (-)
 - 3 Revenues (+)
 - 4 Expenses (-)

INVESTMENTS BY OWNERS AS A BUILDING BLOCK

- **Investments**
 - are the assets the owner puts in the business
 - increase owner's equity

DRAWINGS AS A BUILDING BLOCK

- **Drawings**
 - are withdrawals of cash or other assets by the owner for personal use
 - decrease owner's equity



REVENUES AS A BUILDING BLOCK

- **Revenues**
 - gross increases in owner's equity from business activities entered into for the purpose of earning income
 - may result from sale of merchandise, services, rental of property, or lending money
 - usually result in an increase in an asset

EXPENSES AS A BUILDING BLOCK

Expenses

- decreases in owner's equity that result from operating the business
- cost of assets consumed or services used in the process of earning revenue
- examples: utility expense, rent expense, supplies expense, and tax expense

INCREASES AND DECREASES IN OWNER'S EQUITY

- INCREASES**



**Investments
by Owner**



Revenues



Owner's Equity

- DECREASES**



**Withdrawals
by Owner**

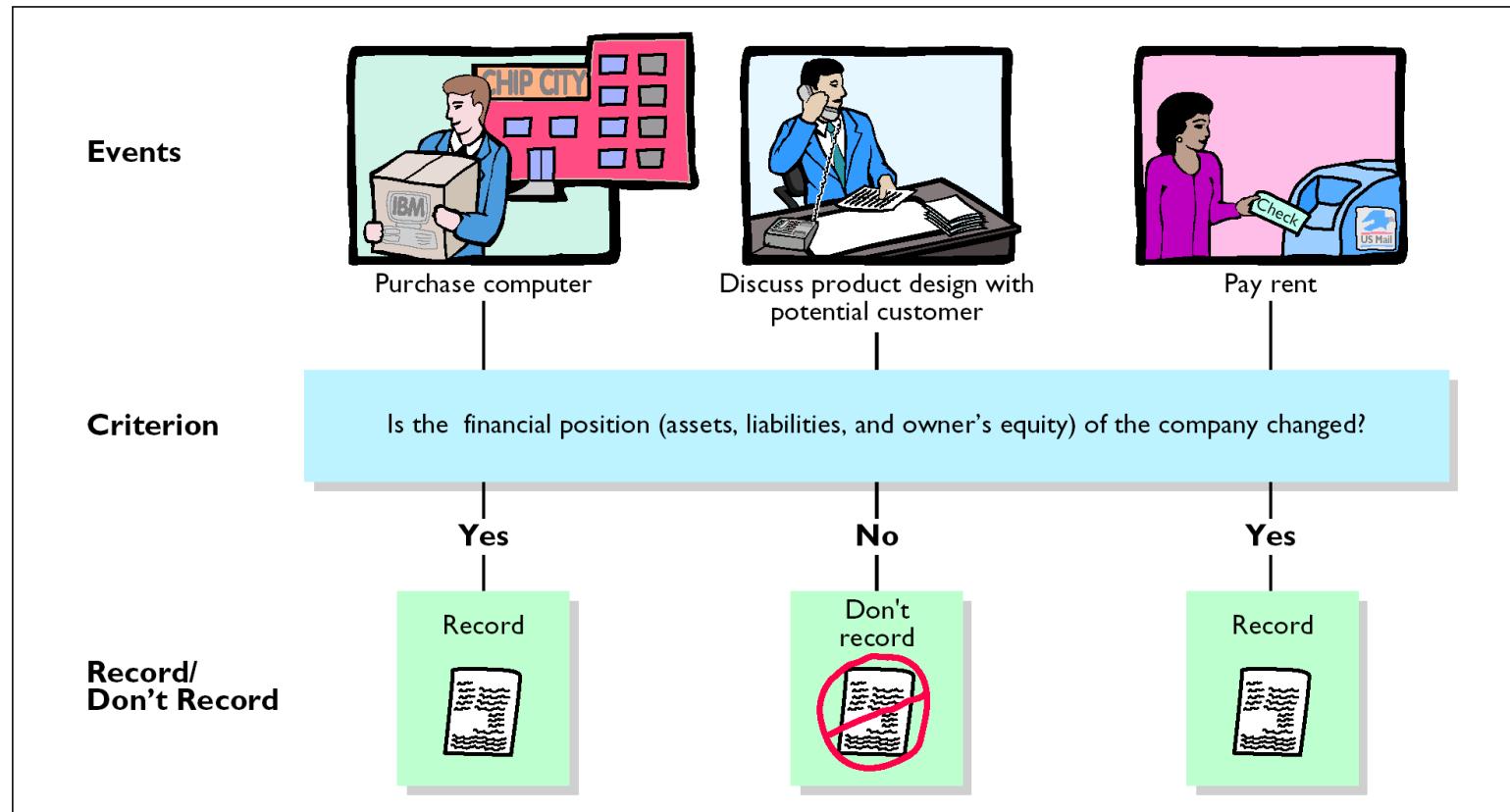


Expenses



TRANSACTION IDENTIFICATION PROCESS

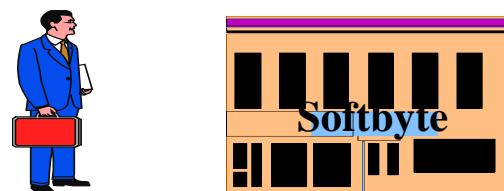
STUDY OBJECTIVE 6



TRANSACTION ANALYSIS

TRANSACTION 1

- Ray Neal decides to open a computer programming service.
- On September 1, he invests \$15,000 cash in the business, which he names Softbyte.



TRANSACTION ANALYSIS

TRANSACTION 1 SOLUTION

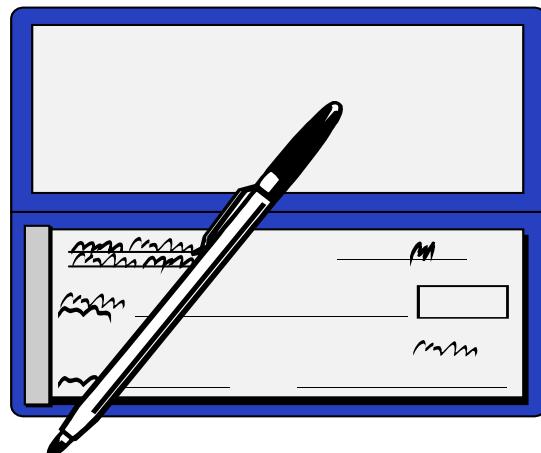
•
$$\begin{array}{rcl} \underline{\text{Assets}} & = & \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}} \\ \underline{\text{Cash}} & & \underline{\text{R. Neal, Capital}} \\ \\ \underline{+ 15,000} & & \underline{\text{Investment}} \quad \underline{+ 15,000} \\ \$15,000 & = & \$15,000 \end{array}$$

There is an increase in the asset **Cash**,
\$15,000, and an equal increase in the owner's
equity, **R. Neal, Capital**, **\$15,000**.

TRANSACTION ANALYSIS

TRANSACTION 2

- **Softbyte purchases computer equipment for \$7,000 cash.**



TRANSACTION ANALYSIS

TRANSACTION 2 SOLUTION

- $\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$
- $\underline{\text{Cash}} + \underline{\text{Equipment}} = + \underline{\text{R. Neal, Capital}}$
- Old
- \$15,000 = \$15,000
- (2) $\underline{- 7,000 + 7,000}$
- New
- \$ 8,000 + \$7,000 = \$15,000

Cash is decreased by \$7,000 and the asset Equipment is increased by \$7,000.

TRANSACTION ANALYSIS

TRANSACTION 3

- **Softbyte** purchases supplies expected to last for several months for **\$1,600** from **Acme Supply Company**.
- **Acme** agrees to allow **Softbyte** to pay this bill next month, in October.
- This transaction is referred to as a purchase on account or a credit purchase.



TRANSACTION ANALYSIS

TRANSACTION 3 SOLUTION

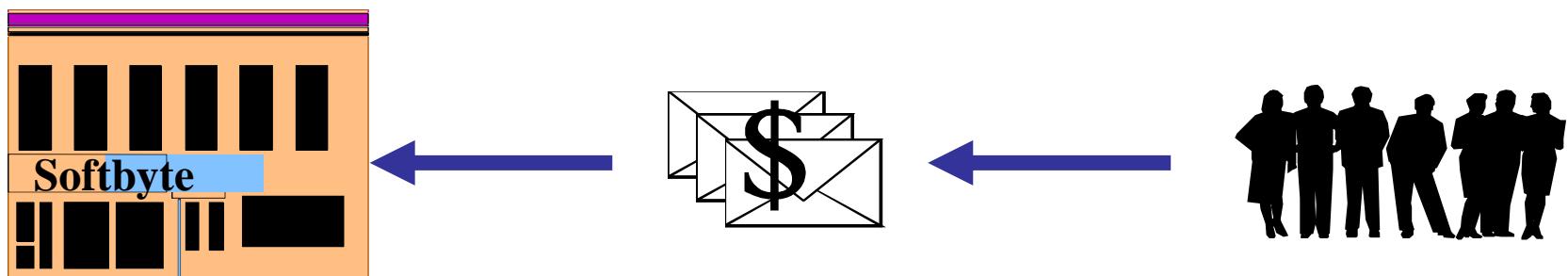
	<u>Assets</u>	=	<u>Liabilities</u>	<u>+ Owner's Equity</u>
	<u>Cash</u> + <u>Supplies</u> + <u>Equip.</u>	=	<u>Accts. Pay.</u>	<u>+ R. Neal, Capital</u>
• Old	\$8,000	+ \$7,000	=	\$15,000
• (3)	<u>+ \$1,600</u>		<u>+ \$1,600</u>	
• New	\$8,000 + \$1,600 + \$7,000	=	+ \$1,600 +	\$15,000
	$\underbrace{\hspace{10em}}$ \$16,600		$\underbrace{\hspace{10em}}$ \$16,600	

The asset **Supplies** is increased by **\$1,600**,
and the liability **Accounts Payable** is
increased by the same amount.

TRANSACTION ANALYSIS

TRANSACTION 4

- **Softbyte receives \$1,200 cash from customers for programming services it has provided.**
- This transaction represents the **Softbyte's principal revenue-producing activity.**



TRANSACTION ANALYSIS

TRANSACTION 4 SOLUTION

	<u>Assets</u>	=	<u>Liabilities</u>	<u>+ Owner's Equity</u>
	<u>Cash</u> + <u>Supplies</u> + <u>Equip.</u>	=	<u>Accts. Pay.</u>	<u>R. Neal, Capital</u>
• Old	\$8,000 + \$1,600 + \$7,000	=	\$1,600	\$15,000
• (4) <u>+ 1,200</u>				<u>+ 1,200</u>
• New	<u>\$9,200 + \$1,600 + \$7,000</u>	=	<u>\$1,600</u>	<u>\$16,200</u>
	$\underbrace{\hspace{10em}}$ \$17,800		$\underbrace{\hspace{10em}}$ \$17,800	

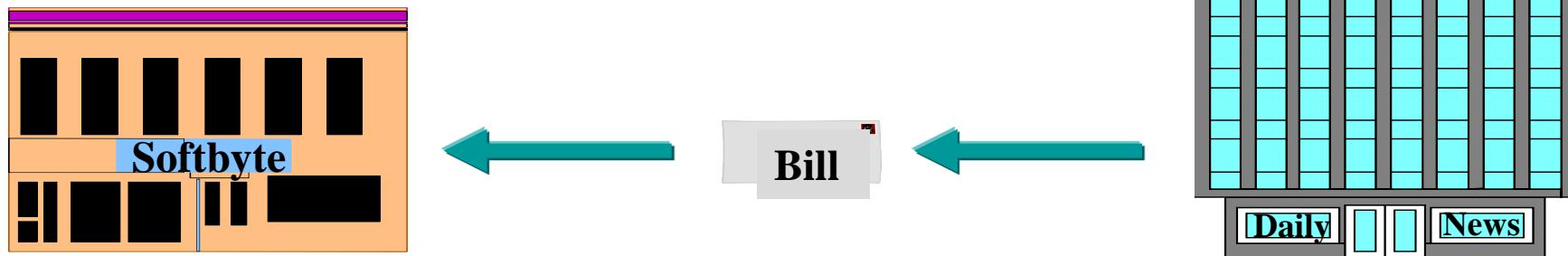
Cash is increased by \$1,200 and R. Neal, Capital is increased by \$1,200.

TRANSACTION ANALYSIS

TRANSACTION

5

- **Softbyte** receives a bill for \$250 from the **Daily News** for advertising but postpones payment of the bill until a later date.



TRANSACTION ANALYSIS

TRANSACTION 5 SOLUTION

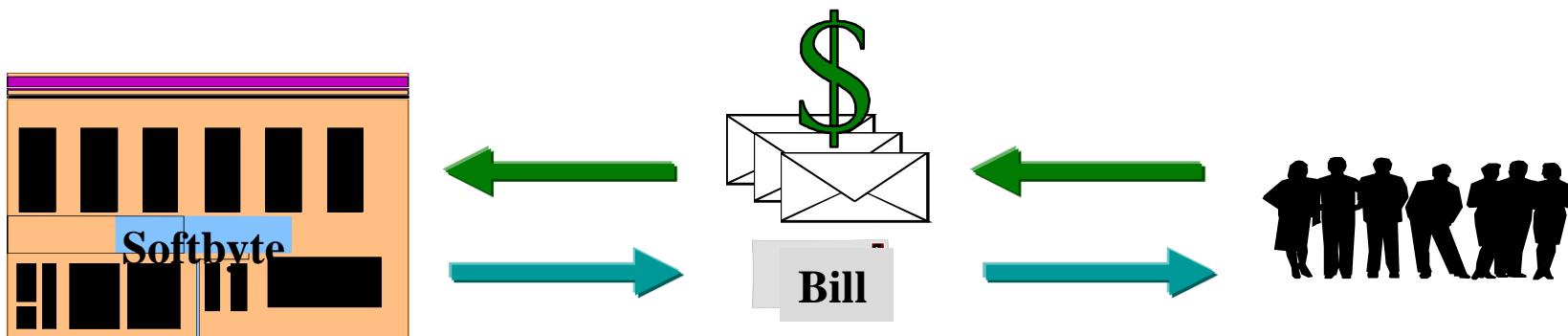
- | | <u>Assets</u> | = | <u>Liabilities</u> | + | <u>Owner's Equity</u> | |
|-----|---|---|--------------------|-------------------|-------------------------|--|
| | <u>Cash</u> + <u>Supplies</u> + <u>Equip.</u> | = | <u>Accts. Pay.</u> | + | <u>R. Neal, Capital</u> | |
| Old | \$9,200 + \$1,600 + \$7,000 | = | \$1,600 | + | \$16,200 | |
| (5) | <u>Advertising Expense</u> | | + 250 | - | 250 | |
| New | \$9,200 + \$1,600 + \$7,000 | = | \$1,850 | + | \$15,950 | |
| | $\brace{ \quad }$ | | | $\brace{ \quad }$ | | |
| | \$17,800 | | | \$17,800 | | |

Accounts Payable is increased by \$250 and **R. Neal, Capital** is decreased by \$250.

TRANSACTION ANALYSIS

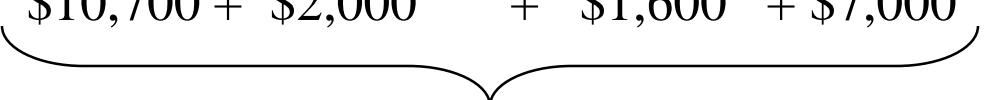
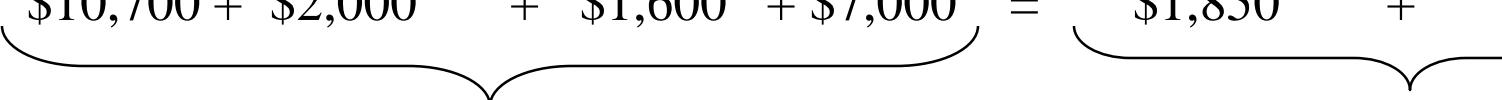
TRANSACTION 6

- **Softbyte** provides \$3,500 of programming services for customers.
- Cash of \$1,500 is received from customers, and the balance of \$2,000 is billed on account.



TRANSACTION ANALYSIS

TRANSACTION 6 SOLUTION

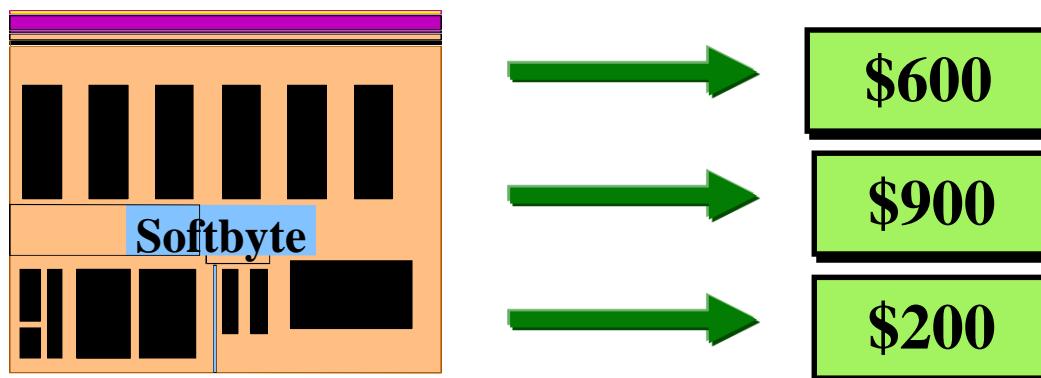
	<u>Assets</u>	=	<u>Liabilities</u>	+ <u>Owner's Equity</u>
•	<u>Cash</u> + <u>Accts. Rec.</u> + <u>Supplies</u> + <u>Equip.</u>	=	<u>Accts. Pay.</u>	+ <u>R. Neal, Capital</u>
•	Old			
•	\$ 9,200	+ \$1,600 + \$7,000	= \$1,850	+ \$15,950
•	(6)			
•	+ <u>1,500</u> + <u>2,000</u>			+ <u>3,500</u>
•	New			
•	\$10,700 + \$2,000	+ \$1,600 + \$7,000	= \$1,850	+ \$19,450
•	 \$21,300	 \$21,300		

Cash is increased by \$1,500; **Accounts Receivable** is increased by \$2,000, and **R. Neal, Capital** is increased by \$3,500.

TRANSACTION ANALYSIS

TRANSACTION 7

- Expenses paid in cash for September are store rent, \$600; employees' salaries, \$900; and utilities, \$200.



TRANSACTION ANALYSIS

TRANSACTION 7 SOLUTION

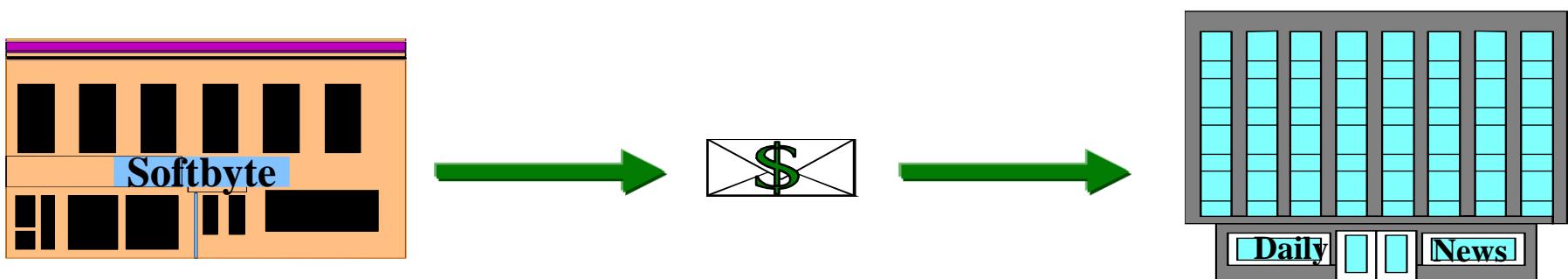
Assets	=	Liabilities	+	Owner's Equity
<u>Cash</u> + <u>Accts. Rec.</u> + <u>Supplies</u> + <u>Equip.</u>	=	<u>Accts. Pay.</u>	+	<u>R. Neal, Capital</u>
Old				
\$10,700 + \$2,000 + \$1,600 + \$7,000	=	\$1,850	+	\$19,450
(7)				
- 1,700		Rent Expense - 600		
		Salaries Expense - 900		
		Utilities Expense - 200		
New				
\$ 9,000 + \$2,000 + \$1,600 + \$7,000	=	\$1,850	+	\$17,750
		\$19,600		\$19,600

Cash is decreased by \$1,700 and R. Neal, Capital is decreased by the same amount.

TRANSACTION ANALYSIS

TRANSACTION 8

- **Softbyte pays its \$250 Daily News advertising bill in cash.**



TRANSACTION ANALYSIS

TRANSACTION 8 SOLUTION

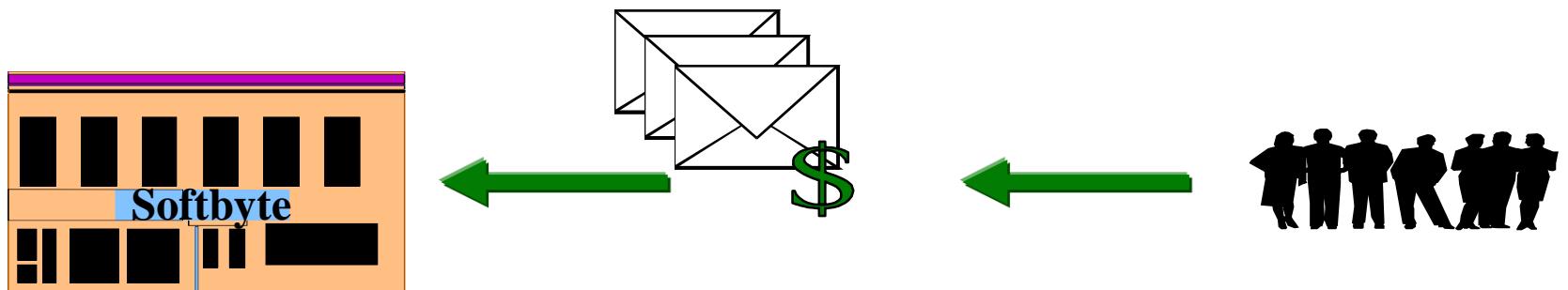
- Assets = Liabilities + Owner's Equity
- Cash + Accts. Rec. + Supplies + Equip. = Accts. Pay. + R. Neal, Capital
- Old
- \$9,000 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$17,750
- (8)- 250 - 250 .
- New
- $\underbrace{\$8,750 + \$2,000 + \$1,600 + \$7,000}_{\$19,350} = \underbrace{\$1,600}_{\$19,350} + \$17,750$

Both **Cash** and **Accounts Payable** are decreased by **\$250**. Since the expense was previously recorded, it is not recorded now.

TRANSACTION ANALYSIS

TRANSACTION 9

- The sum of \$600 in cash is received from customers who have previously been billed for services (in Transaction 6).



TRANSACTION ANALYSIS

TRANSACTION 9 SOLUTION

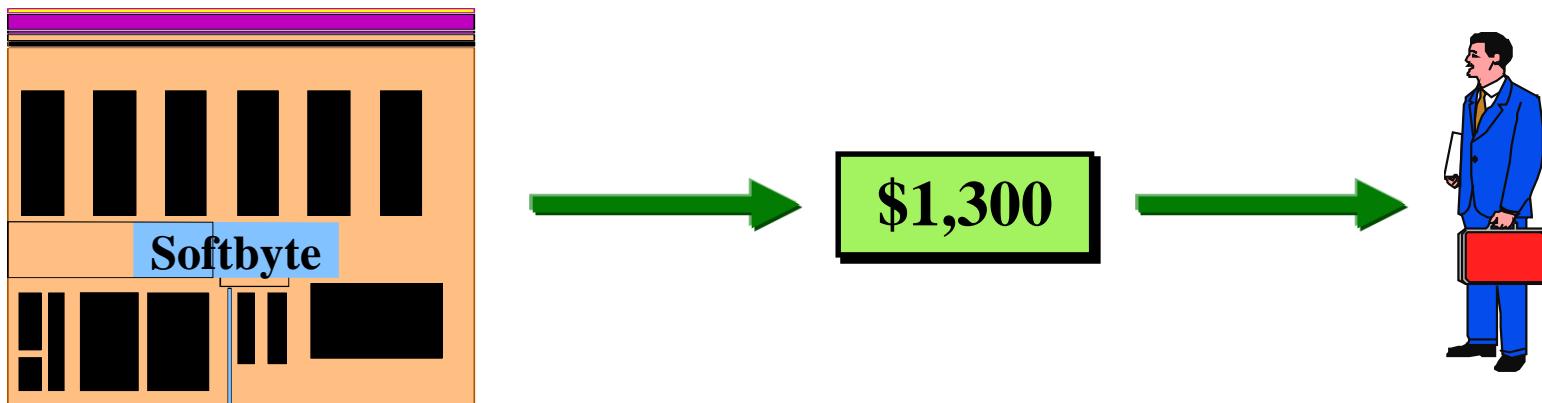
- $\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$
- $\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$
- Old
- $\$8,750 + \$2,000 + \$1,600 + \$7,000 = \$1,600 + \$17,750$
- $(9) + 600 - 600$.
- New
- $\underbrace{\$9,350 + \$1,400}_{\$19,350} + \underbrace{\$1,600 + \$7,000}_{\$19,350} = \underbrace{\$1,600}_{\$19,350} + \underbrace{\$17,750}_{\$19,350}$

Cash is increased by \$600 and Accounts Receivable is decreased by the same amount. R. Neal, Capital is not increased because the revenue was already recorded.

TRANSACTION ANALYSIS

TRANSACTION 10

- **Ray Neal withdraws \$1,300 in cash from the business for his personal use.**



TRANSACTION ANALYSIS

TRANSACTION 10 SOLUTION

- $\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$
- $\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$
- Old
- $\$9,350 + \$1,400 + \$1,600 + \$7,000 = \$1,600 + \$17,750$
- (10)
- $\underline{- 1,300} \qquad \qquad \qquad \underline{\text{Drawing}} - \underline{1,300}$
- New
- $\underbrace{\$8,050 + \$1,400}_{\$18,050} + \underbrace{\$1,600 + \$7,000}_{\$18,050} = \underbrace{\$1,600}_{\$16,450} + \underbrace{\$17,750 - \$1,300}_{\$16,450}$

Cash is decreased by \$1,300 and **R. Neal, Capital** is decreased by the same amount. This is not an expense, but rather a withdrawal of owner's equity.

FINANCIAL STATEMENTS

STUDY OBJECTIVE 8

•Four financial statements are prepared from the summarized accounting data:

- **Income Statement**
revenues and expenses and resulting net income or net loss for a specific period of time
- **Owner's Equity Statement**
Changes in owner's equity for a specific period of time
- **Balance Sheet**
assets, liabilities, and owner's equity at a specific date
- **Statement of Cash Flows**
cash inflows (receipts) and outflows (payments) for a specific period of time

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.

Income Statement

For the Month Ended September 30, 2005

Revenues

Service revenue \$ 4,700

Expenses

Salaries expense \$ 900

Rent expense 600

Advertising expense 250

Utilities expense 200

Total expenses 1,950

Net income • \$ 2,750

Net income of \$2,750 shown on the income statement is added to the beginning balance of owner's capital in the owner's equity statement.

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

**SOFTBYTE, INC.
Owner's Equity Statement
For the Month Ended September 30, 2005**

Retained earnings, September 1, 2005	\$ -0-
Add: Investments	\$ 15,000
Net income	2,750
	17,750
Less: Drawings	1,300
Retained earnings, September 30, 2005	•\$16,450

Net income of \$2,750 carried forward from the income statement to the owner's equity statement. The owner's capital of **\$16,450** at the end of the reporting period is shown as the final total of the owner's equity column of the Summary of Transactions (Illustration 1-8).

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.	
Balance Sheet	
September 30, 2005	
	Assets
Cash	\$ 8,050
Accounts receivable	1,400
Supplies	1,600
Equipment	7,000
Total assets	\$ 18,050
	Liabilities and Owner's Equity
Liabilities	
Accounts payable	\$ 1,600
Owner's equity	
R. Neal, capital	•16,450
Total liabilities and owner's equity	\$ 18,050

Owner's capital of **\$16,450** at the end of the reporting period shown in the owner's equity statement is shown on the balance sheet.

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.	
Balance Sheet	
September 30, 2005	
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	
R. Neal, capital	16,450
Total liabilities and owner's equity	<u>\$ 18,050</u>

Cash of \$8,050 on the balance sheet is reported on the statement of cash flows.

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.

Statement of Cash Flows

For the Month Ended September 30, 2005

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	
Sale of common stock	\$ 15,000
Payment of cash dividends	(1,300)
Net cash provided by financing activities	13,700
Net increase in cash	8,050
Cash at the beginning of the period	—0—
Cash at the end of the period	•\$ 8,050

Cash of **\$8,050** on the balance sheet and statement of cash flows is shown as the final total of the cash column of the Summary of Transactions (Illustration 1-8).