

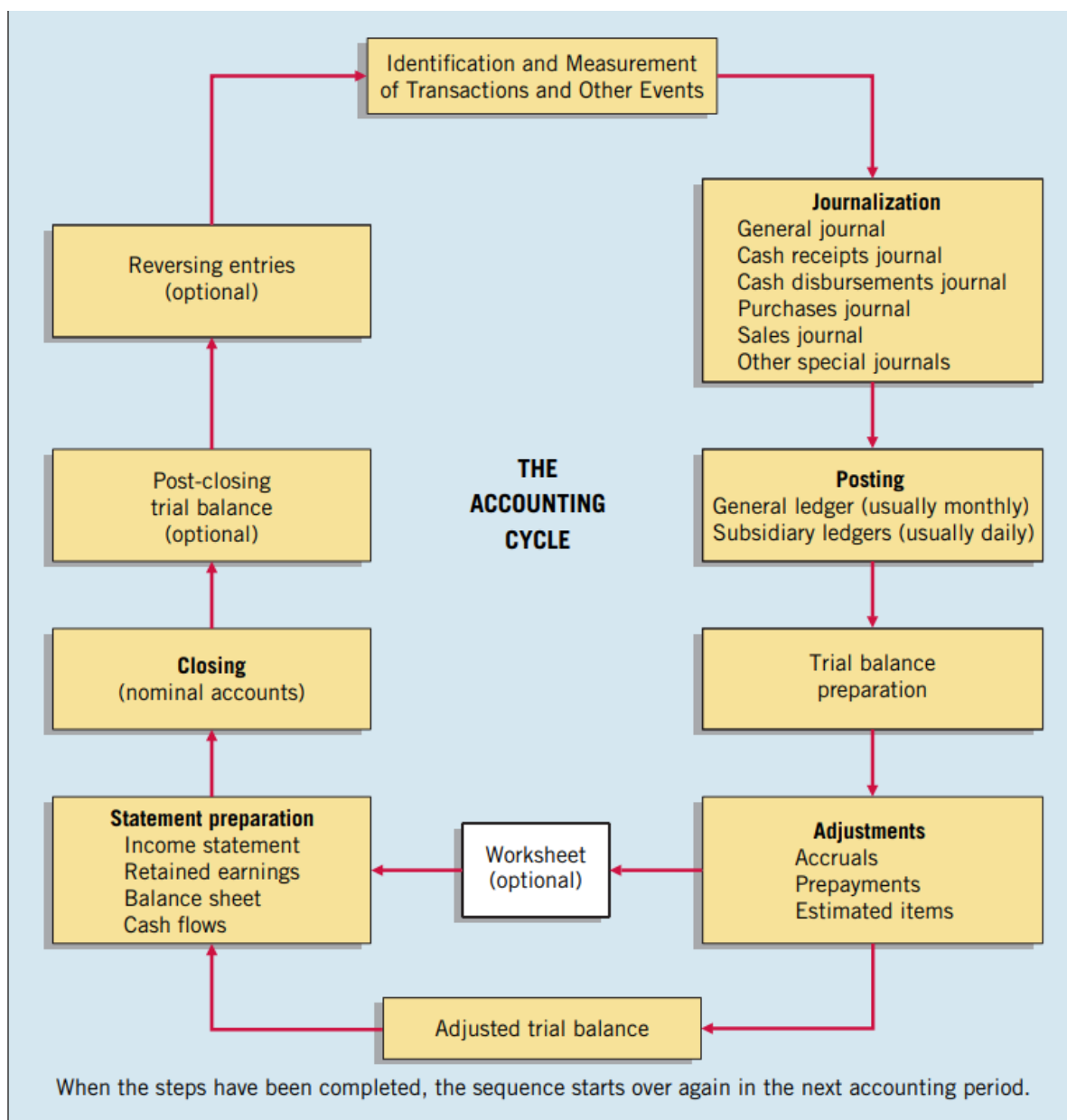
Chapter 2

Introduction to Financial Statements: Accounting Equation & Transaction Analysis

Topics:

- Accounting transactions
- Effects of accounting transactions on accounting equation

The Accounting Cycle:



A company normally uses these accounting procedures to record transactions and prepare financial statements.

Identifying and Recording Transactions and Other Events:

The first step in the accounting cycle is analysis of transactions and selecting other events. The first problem is to determine what to record. Although GAAP provides guidelines, no simple rules exist that state which events a company should record. Although changes in a company's personnel or managerial policies may be important, the company should not record these items in the accounts. On the other hand, a company should record all cash sales or purchases—no matter how small. An item should be recognized in the financial statements if it is an element, is measurable, and is relevant and representationally faithful.

The FASB uses the phrase “transactions and other events and circumstances that affect a business enterprise” to describe the sources or causes of changes in an entity's assets, liabilities, and equity. Events are of two types. (1) External events involve interaction between an entity and its environment, such as a transaction with another entity, a change in the price of a good or service that an entity buys or sells, a flood or earthquake, or an improvement in technology by a competitor. (2) Internal events occur within an entity, such as using buildings and machinery in operations, or transferring or consuming raw materials in production processes.

Transactions are types of external events. They may be an exchange between two entities where each receives and sacrifices value, such as purchases and sales of goods or services. Or, transactions may be transfers in one direction only. For example, an entity may incur a liability without directly receiving value in exchange, such as charitable contributions

Analysis of Transactions: (Showing the effects of transactions on the Accounting Equation)

Example:

- 1) Livon invested \$50,000 cash in the business.
- 2) Paid \$40,000 cash for Land.
- 3) Purchased \$500 of Office Supplies on account.
- 4) Received \$5,500 cash from clients for accounting service revenue earned.
- 5) Performed accounting service for a client on account, \$3,000.
- 6) Paid cash expenses: rent, \$1,100; Employee salary, \$1,200; utilities, \$400.
- 7) Paid \$400 on the account payable created in transaction-3.
- 8) Remodeled his personal residence. (This is not a business transaction)
- 9) Received \$1,000 on the account receivable created in transaction-5.
- 10) Sold land for cash equal to its cost of \$22,000.
- 11) Withdraw \$2,100 cash for personal living expenses.

Transaction Analysis

Date	Description	Assets				=	Liabilities & Owners Equity	
		Cash	Accounts receivable	Office Supplies	Land		Account Payable	Capital
1	Investment	+50,000						+50,000
2	Paid for land	-40,000			+40,000			
3	Purchased office supplies on account			+500			+500	
4	Service Revenue for cash	+5,500	-	-	-		-	+5,500
5	Service Revenue on account	-	+3,000	-	-		-	+3,000
6	Rent exp. Salary exp. Utilities exp.	-1,100 -1,200 - 400	-	-	-		-	-1,100 - 1,200 - 400
7	Paid on account	-400	-	-	-		-400	-

8	Not a business transaction	-				-	-
9	Received on account	+1,000	-1000	-	-	-	-
10	Sold land for cash	+22,000	-	-	-22,000	-	-
11	Withdrawal	-2,100	-	-	-	-	- 2,100
	Total	33,300	2,000	500	18,000	100	53,700
		53,800				53,800	

Preparation of Financial Statements from Transaction Analysis:

Livon's

Income Statement

For the month/year ended 31st Dec. 2019

Revenues:

Service Revenue (5,500+3,000).....\$ 8,500

Expenses:

Salary Expense.....\$1,200

Rent Expense.....1,100

Utilities Expense..... 400 2,700

Net Income / Net Profit.....\$ 5,800

Livon's

Owner's Equity Statement

For the month/year ended 31st Dec. 2019

Capital, January 1, 2019.....\$ 000

Add: Investment by owner.....50,000

Add: Net Income for the month..... 5,800

55,800

Less: Withdrawals by owner..... 2,100

Capital, Dec. 31st, 2019..... \$ 53,700

Livon's

Balance Sheet

As on Dec. 31st, 2019

Assets		Liabilities & owners' equity	
Cash.....	\$33,300	Accounts Payable.....	\$ 100
Accounts Receivable.....	2,000	<u>Owner's Equity:</u>	
Office Supplies.....	500	Capital.....	<u>53,700</u>
Land.....	<u>18,000</u>	Total Liabilities and	
Total Assets.....	<u>\$ 53,800</u>	Owner's Equity.....	<u>\$ 53,800</u>

Question: 1

Shanta Reed owns and operates an interior design studio called “Shanta Interiors”. The following amounts summarize the financial position of her business on March 31, 2007:

<u>Assets</u>				=	<u>Liabilities + Owner's Equity</u>	
Cash +	A / R +	Supplies +	Land	=	A / P +	Shanta's Capital
Bal. 1,250	1,500		12,000		8,000	6,750

During April 2007, the following transactions occurred:

- Shanta invested \$ 15,000 in the business.
- Performed services for a client and received cash of \$800.
- Paid off the beginning balance of Accounts Payable.
- Purchased supplies on account, \$500.
- Collected cash from a client on account, \$1,000.
- Consulted on the interior design of a major office building and billed the client for the service rendered, \$2,500.
- Recorded the following business expenses for the month:
 - Paid office rent ----\$400.
 - Paid advertising --- \$300.
 - Paid utilities ----- \$300.
- Sold supplies to another business for \$ 150 cash, which was the cost of the supplies.
- Purchased a Land for \$8,000; cash paid \$3,000 and the balance will be paid in the next month.
- Withdraw cash of \$1,500 for personal use.

Analyze the effects of the above transactions on the accounting equation.

Date	Description	Assets				Liabilities & owners' equity	
		Cash	A/R	Supplies	Land	A/P	Capital
	Beginning balance	1,250	1,500	-	12,000	8,000	6,750
a	Investment	15,000	-	-	-	-	+15,000
b	Service Revenue for cash	+800	-	-	-	-	+800
c	Paid off account payable	-8,000	-	-	-	-8,000	-
d	Purchased supplies on account	-	-	+500	-	+500	-
e	Collected on account	+1,000	-1,000	-	-	-	-
f	Service on account	-	+2,500	-	-	-	+2,500
g	Rent Exp. Advert. Exp. Utilities Exp.	-1,000	-	-	-	-	-400 -300 -300
h	Sold supplies for cash	+150	-	-150	-	-	-
i	Purchased land	-3,000	-	-	+8,000	+5,000	-
j	Withdrawals	-1,500	-	-	-	-	-1,500
	Total	4,700	3,000	350	20,000	5,500	22,550
		28,050				28,050	

Problem: Try yourself

Aisha owns and operates an interior design studio called “**Aisha Interiors**”. The following amounts summarize the financial position of her business on March 31, 2012:

<u>Assets</u>				=	<u>Liabilities + Owner's Equity</u>	
Cash +	A / R +	Supplies +	Land	=	A / P +	Aisha's Capital
Bal. 5,000	4,500	500	50,000		5,100	54,900

During April 2012, the following transactions occurred:

- k) **Aisha's** additional investment \$30,000 in the business.
- l) Performed services for a client and received cash of \$8,000.
- m) Paid off the beginning balance of Accounts Payable as final settlement at \$5,000.
- n) Purchased supplies on account, \$500.
- o) Cash collected on account, \$4,300 and allowed them \$200 as discount.
- p) Consulted on the interior design of a major office building and billed the client for the service rendered, \$6,500.
- q) Recorded the following business cash expenses for the month:
 - i) office rent ----\$5,000, ii) advertising ---\$3,000, iii) utilities -----\$7,000.
- r) Sold supplies to another business for \$ 200 cash, cost of which was \$220.
- s) Uncollectible Expense \$200 on Accounts Receivable.
- t) Purchased a Land for \$5,000; cash paid \$2,000 and the balance being paid using credit card.
- u) Salary Expense due but not paid \$ 500.
- v) Withdraw cash of \$1,000 for personal use.

Required: a) Analyze the effects of the above transactions on the accounting equation.
 b) Prepare an Income Statement, Owners' Equity Statement and a Balance Sheet.