1

Accounting Concepts and Procedures

DID YOU KNOW? By 2007 Best Buy employed 10,000 geek squad agents, 3,000 home theatre installers, and 3,000 vehicle installers. Revenues and net income are greatest for Best Buy in quarter 4 (the holiday seasons for the United States and Canada). Visit *www.BestBuy.com* to find more information about Best Buy.

LEARNING OBJECTIVES

1. Defining and listing the functions of accounting.
2. Recording transactions in the basic accounting equation.
3. Seeing how revenue, expenses, and withdrawals expand the basic accounting equation.
4. Preparing an income statement, a statement of owner's equity, and a balance sheet.

Companies like Best Buy have to comply with many federal statutes. In 2002 a federal statute called the Sarbanes-Oxley Act was passed to prevent fraud at public companies. This act requires a closer look at the internal controls and the accuracy of the financial results of a company.

Accounting is the language of business; it provides information to managers, owners, investors, government agencies, and others inside and outside the organization. Accounting provides answers and insights to questions like these:

- Should I invest in Best Buy or Wal-Mart stock?
- How will increasing fuel costs affect American Airlines?
- Can United Airlines pay its debt obligations?
- What percentage of Ford's marketing budget is allocated to e-business? How does that percentage compare with the competition? What is the overall financial condition of Ford?

Smaller businesses also need answers to their financial questions:

- At a local Walgreens, did business increase enough over the last year to warrant hiring a new assistant?
- Should Local Auto Detailing Co. spend more money to design, produce, and send out new brochures in an effort to create more business?
- What role should the Internet play in the future of business spending?

Accounting is as important to individuals as it is to businesses; it answers questions like these:

- Should I take out a loan to buy a new Toyota FJ Cruiser or wait until I can afford to pay cash for it?
- Would my money work better in a money market or in the stock market?

The accounting process analyzes, records, classifies, summarizes, reports, and interprets financial information for decision makers—whether individuals, small businesses, large corporations, or governmental agencies—in a timely fashion. It is important that students understand the "whys" of this accounting process. Just knowing the mechanics is not enough.

The three main categories of business organization are (1) sole proprietorships, (2) partnerships, and (3) corporations. Let's define each of them and look at their advantages and disadvantages. This information also appears in Table 1.1.

Sole Proprietorship A **sole proprietorship,** such as Lee's Nail Care, is a business that has one owner. That person is both the owner and the manager of the business. An advantage of a sole proprietorship is that the owner makes all the decisions for the business. A disadvantage is that if the business cannot pay its obligations, the business owner must pay them, which means that the owner could lose some of his or her personal assets (e.g., house or savings).

Sole proprietorships are easy to form. They end if the business closes or when the owner dies.

Partnership A **partnership,** such as Miller and Kaminsky, is a form of business ownership that has at least two owners (partners). Each partner acts as an owner of the company, which is an advantage because the partners can share the decision making and the risks of the business. A disadvantage is that, as in a sole proprietorship, the partners' personal assets could be lost if the partnership cannot meet its obligations.

Partnerships are easy to form. They end when a partner dies or leaves the partnership, or when the partners decide to close the business.

Corporation A **corporation,** such as Best Buy, is a business owned by stockholders. The corporation may have only a few stockholders, or it may have many stockholders. The

TABLE 1.1 Types of Business Organizations

	Sole Proprietorship (Lee's Nail Care)	Partnership (Miller and Kaminsky)	Corporation (Best Buy)
Ownership	Business owned by one person.	Business owned by more than one person.	Business owned by stockholders.
Formation	Easy to form.	Easy to form.	More difficult to form.
Liability	Owner could lose personal assets to meet obligations of business.	Partners could lose personal assets to meet obligations of partnership.	Limited personal risk. Stockholders' loss is limited to their investment in the company.
Closing	Ends with death of owner or closing of business.	Ends with death of partner or closing of business.	Can continue indefinitely.

stockholders are not personally liable for the corporation's debts, and they usually do not have input into the business decisions.

Corporations are more difficult to form than sole proprietorships or partnerships. Corporations can exist indefinitely.

Many corporate executives feel that Sarbanes-Oxley is too strict and results in too high of a cost to implement.

Classifying Business Organizations

Whether we are looking at a sole proprietorship, a partnership, or a corporation, the business can be classified by what the business does to earn money. Companies are categorized as service, merchandise, or manufacturing businesses.

A limo service is a good example of a **service company** because it provides a service. The first part of this book focuses on service businesses.

Gap and JCPenney sell products. They are called merchandise companies. **Merchandise companies** can either make their own products or sell products that are made by another supplier. Companies such as Intel and Ford Motor Company that make their own products are called **manufacturers.** (See Table 1.2.)

Definition of Accounting

LO1

Accounting (also called the accounting process) is a system that measures the activities of a business in financial terms. It provides various reports and financial statements that show how the various transactions the business undertook (e.g., buying and selling goods) affected the business. This accounting process performs the following functions:

- **Analyzing:** Looking at what happened and how the business was affected.
- **Recording:** Putting the information into the accounting system.
- **Classifying:** Grouping all the same activities (e.g., all purchases) together.
- **Summarizing:** Totaling the results.
- **Reporting:** Issuing the statements that tell the results of the previous functions.

TABLE 1.2 Examples of Service, Merchandise, and Manufacturing Businesses

Service Businesses	Merchandise Businesses	Manufacturing Businesses
Lee's Nail Care	Macy's	Anheuser-Busch
eBay	JCPenney	Ford
Dr. Wheeler, M.D.	Amazon.com	Toro
Accountemps	Home Depot	Levi's
Langley Landscaping	Gap	Intel

Appendix A will look at the annual report of Kellogg Company.

- **Interpreting:** Examining the statements to determine how the various pieces of information they contain relate to each other.
- **Communication:** Providing the reports and financial statements to people who are interested in the information, such as the business's decision makers, investors, creditors, and government agencies (e.g., the Internal Revenue Service).

As you can see, a lot of people use these reports. A set of procedures and guidelines were developed to make sure that everyone prepares and interprets them the same way. These guidelines are known as **generally accepted accounting principles (GAAP).**

Now let's look at the difference between bookkeeping and accounting. Keep in mind that we use the terms *accounting* and the *accounting process* interchangeably.

Difference between Bookkeeping and Accounting

Confusion often arises concerning the difference between bookkeeping and accounting. **Bookkeeping** is the recording (record keeping) function of the accounting process; a bookkeeper enters accounting information in the company's books. An accountant takes that information and prepares the financial statements that are used to analyze the company's financial position. Accounting involves many complex activities. Often, it includes the preparation of tax and financial reports, budgeting, and analyses of financial information.

Today, computers are used for routine bookkeeping operations that used to take weeks or months to complete. The text explains how the advantages of the computer can be applied to a manual accounting system by using hands-on knowledge of how accounting works. Basic accounting knowledge is needed even though computers can do routine tasks. QuickBooks, Excel, and Peachtree are popular software packages in use today.

Learning Unit 1-1 The Accounting Equation

Assets, Liabilities, and Equities

Let's begin our study of accounting concepts and procedures by looking at a small business: Mia Wong's law practice. Mia decided to open her practice at the end of August. She consulted her accountant before she made her decision. The accountant told her some important things before she made this decision. First, he told her the new business would be considered a separate business entity whose finances had to be kept separate and distinct from Mia's personal finances. The accountant went on to say that all transactions can be analyzed using the basic accounting equation: Assets = Liabilities + Owner's Equity.

Mia had never heard of the basic accounting equation. She listened carefully as the accountant explained the terms used in the equation and how the equation works.

Assets Cash, land, supplies, office equipment, buildings, and other properties of value *owned* by a firm are called **assets.**

Equities The rights of financial claim to the assets are called **equities.** Equities belong to those who supply the assets. If you are the only person to supply assets to the firm, you have the sole rights or financial claims to them. For example, if you supply the law firm with $6,000 in cash and $8,000 in office equipment, your equity in the firm is $14,000.

Relationship between Assets and Equities The relationship between assets and equities is

Assets = Equities
(Total value of items *owned* by business) (Total claims against the assets)

The total dollar value of the assets of your law firm will be equal to the total dollar value of the financial claims to those assets, that is, equal to the total dollar value of the equities.

The total dollar value is broken down on the left-hand side of the equation to show the specific items of value owned by the business and on the right-hand side to show the types of claims against the assets owned.

Liabilities A firm may have to borrow money to buy more assets; when it does, it means the firm *buys assets on account* (buy now, pay later). Suppose the law firm purchases a new computer for $3,000 on account from Dell, and the company is willing to wait 10 days for payment. The law firm has created a **liability:** an obligation to pay that comes due in the future. Dell is called the **creditor.** This liability—the amount owed to Dell—gives the store the right, or the financial claim, to $3,000 of the law firm's assets. When Dell is paid, the store's rights to the assets of the law firm will end because the obligation has been paid off.

Basic Accounting Equation To best understand the various claims to a business's assets, accountants divide equities into two parts. The claims of creditors—outside persons or businesses—are labeled *liabilities*. The claim of the business's owner is labeled **owner's equity.** Let's see how the accounting equation looks now.

Assets – Liabilities = Owner's Equity

Assets = **Equities**

1. Liabilities: rights of creditors
2. Owner's equity: rights of owner

Assets = Liabilities + Owner's Equity

LO2

The total value of all the assets of a firm equals the combined total value of the financial claims of the creditors (liabilities) and the claims of the owners (owner's equity). This calculation is known as the **basic accounting equation.** The basic accounting equation provides a basis for understanding the conventional accounting system of a business. The equation records business transactions in a logical and orderly way that shows their impact on the company's assets, liabilities, and owner's equity.

Importance of Creditors Another way of presenting the basic accounting equation is

Assets – Liabilities = Owner's Equity

This form of the equation stresses the importance of creditors. The owner's rights to the business's assets are determined after the rights of the creditors are subtracted. In other words, creditors have first claim to assets. If a firm has no liabilities—therefore no creditors—the owner has the total rights to assets. Another term for the owner's current investment, or equity, in the business's assets is **capital.**

In accounting, capital does not mean cash. Capital is the owner's current investment, or equity, in the assets of the business.

As Mia Wong's law firm engages in business transactions (paying bills, serving customers, and so on), changes will take place in the assets, liabilities, and owner's equity (capital). Let's analyze some of these transactions.

Transaction A Aug. 28: Mia invests $6,000 in cash and $200 of office equipment into the business.

On August 28, Mia withdraws $6,000 from her personal bank account and deposits the money in the law firm's newly opened bank account. She also invests $200 of office equipment in the business. She plans to be open for business on September 1. With the help of her accountant, Mia begins to prepare the accounting records for the business. We put this information into the basic accounting equation as follows:

Assets			=	Liabilities + Owner's Equity
Cash	+	Office Equipment	=	Mia Wong, Capital
$6,000	+	$200	=	$6,200

$6,200 = $6,200

Note that the total value of the assets, cash, and office equipment—$6,200—is equal to the combined total value of liabilities (none, so far) and owner's equity ($6,200). Remember, Mia has supplied all the cash and office equipment, so she has the sole financial claim to the assets. Note how the heading "Mia Wong, Capital" is written under the owner's equity heading. The $6,200 is Mia's investment, or equity, in the firm's assets.

Transaction B Aug. 29: Law practice buys office equipment for cash, $500.

From the initial investment of $6,000 cash, the law firm buys $500 worth of office equipment (such as a computer desk), which lasts a long time, whereas **supplies** (such as pens) tend to be used up relatively quickly.

	Assets			= Liabilities +	Owner's Equity
	Cash	+	Office Equipment	=	Mia Wong, Capital
BEGINNING BALANCE	$6,000	+	$200	=	$6,200
TRANSACTION	−500		+500		
ENDING BALANCE	$5,500	+	$700	=	$6,200

$6,200 = $6,200

Shift in Assets As a result of the last transaction, the law office has less cash but has increased its amount of office equipment. This **shift in assets** indicates that the makeup of the assets has changed, but the total of the assets remains the same.

Suppose you go food shopping at Wal-Mart with $100 and spend $60. Now you have two assets, food and money. The composition of the assets has *shifted*—you have more food and less money than you did—but the *total* of the assets has not increased or decreased. The total value of the food, $60, plus the cash, $40, is still $100. When you borrow money from the bank, on the other hand, you increase cash (an asset) and increase liabilities at the same time. This action results in an increase in assets, not just a shift.

An accounting equation can remain in balance even if only one side is updated. The key point to remember is that the left-hand-side total of assets must always equal the right-hand-side total of liabilities and owner's equity.

Transaction C Aug. 30: Buys additional office equipment on account, $300.

The law firm purchases an additional $300 worth of chairs and desks from Wilmington Company. Instead of demanding cash right away, Wilmington agrees to deliver the equipment and to allow up to 60 days for the law practice to pay the invoice (bill).

This liability, or obligation to pay in the future, has some interesting effects on the basic accounting equation. Wilmington Company accepts as payment a partial claim against the assets of the law practice. This claim exists until the law firm pays off the bill. This unwritten promise to pay the creditor is a liability called **accounts payable.**

	Assets			=	Liabilities	+	Owner's Equity
	Cash	+	Office Equipment	=	Accounts Payable	+	Mia Wong, Capital
BEGINNING BALANCE	$5,500	+	$700	=			$6,200
TRANSACTION			+300		+$300		
ENDING BALANCE	$5,500	+	$1,000	=	$300	+	$6,200

$6,500 = $6,500

When this information is analyzed, we can see that the law practice increased what it owes (accounts payable) as well as what it owns (office equipment) by $300. The law practice gains $300 in an asset but also takes on an obligation to pay Wilmington Company at a future date.

The owner's equity remains unchanged. This transaction results in an increase of total assets from $6,200 to $6,500.

Finally, note that after each transaction the basic accounting equation remains in balance.

LEARNING UNIT 1-1 REVIEW

AT THIS POINT you should be able to

- Define and explain the purpose of the Sarbanes-Oxley Act.
- Define and explain the differences between sole proprietorships, partnerships, and corporations.
- List the functions of accounting.
- Compare and contrast bookkeeping and accounting.
- Explain the role of the computer as an accounting tool.
- State the purpose of the accounting equation.
- Explain the difference between liabilities and owner's equity.
- Define capital.
- Explain the difference between a shift in assets and an increase in assets.

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To test your understanding of this material, complete Self-Review Quiz 1-1. The blank forms you need for all Self-Review quizzes and end-of-chapter material throughout the textbook can be found in the *Study Guide and Working Papers*. The solution to the quiz immediately follows here in the text. If you have difficulty doing the problems, review Learning Unit 1-1 and the solution to the quiz along with a detailed explanation from Jeff Slater, your author. Be sure to check the Slater Web site for student study aids.

Keep in mind that learning accounting is like learning to type: The more you practice, the better you become. You will not be an expert in one day. Be patient. It will all come together.

Self-Review Quiz 1-1

Record the following transactions in the basic accounting equation:

1. Gracie Ryan invests $17,000 to begin a real estate office.
2. The real estate office buys $600 of computer equipment from Wal-Mart for cash.
3. The real estate company buys $800 of additional computer equipment on account from Circuit City.

Solution to Self-Review Quiz 1-1

Assets			=	Liabilities	+	Owner's Equity	
Cash	+	Computer Equipment	=	Accounts Payable	+	Gracie Ryan, Capital	
+$17,000						+$17,000	
17,000			=			17,000	**1. BALANCE**
−600		+$600					
16,400	+	600	=			17,000	**2. BALANCE**
		+800		+$800			
$16,400	+	$1,400	=	$800	+	$17,000	**3. ENDING BALANCE**

$17,800 = $17,800

NEED HELP?

Let's review first: The left side of the accounting equation shows what is owned by the business and the right side of the equation shows you who supplied those assets to a business. Now let's look at the transactions in the solution:

Transaction 1: In your head you must say to yourself, "What did the business get and how did it get it?" The business is getting or increasing its cash by $17,000 and that cash is being supplied by Gracie Ryan. Think of Gracie as increasing her rights in the business since she is supplying cash. Keep in mind that capital does not mean cash. Instead it is what the owner supplies to the business. (Gracie may in the future supply other items to the business.)

So the end result is to put $17,000 on the left side of the equation under cash and put $17,000 under Gracie Ryan, Capital on the right side. The sum of the left side must equal the sum on the right side.

Transaction 2: Here we are NOT looking at the personal finances of Gracie. You must focus on the business. What did the business get and who supplied it to the business?

In this transaction the business is getting $600 of computer equipment by using some of its cash. IT IS SHIFTING ITS ASSETS: MORE EQUIPMENT FOR LESS CASH. Note that capital is not affected since Gracie has not supplied anything new to the business. Note that the right side of the equation is not touched, but the equation still remains in the balance. We are just rearranging the composition of the assets.

Transaction 3: Now the business is getting more equipment but is not paying cash. The equipment is being supplied by a creditor called Accounts Payable. Hopefully in the future the business will be able to pay the creditor back the $800 that it owes. The end result is that the business now has $1,400 in equipment. Note that capital is not affected since no new investments were made by Gracie into the business.

Summary: At the end of these three transactions this company is made up of two assets, Cash $16,400 and Computer Equipment $1,400. The total of the assets was supplied by creditors $800 and the owner Gracie Ryan, Capital $17,000. The sum of the left side must equal the sum of the right side.

Learning Unit 1-2 The Balance Sheet

The balance sheet shows the company's financial position as of a particular date. (In our example, that date is at the end of August.)

In the first learning unit, the transactions for Mia Wong's law firm were recorded in the accounting equation. The transactions we recorded occurred before the law firm opened for business. A statement called a **balance sheet** or **statement of financial position** can show the history of a company before it opened. The balance sheet is a formal statement that presents the information from the ending balances of both sides of the accounting equation. Think of the balance sheet as a snapshot of the business's financial position as of a particular date.

Let's look at the balance sheet of Mia Wong's law practice for August 31, 200X, shown in Figure 1.1. The figures in the balance sheet come from the ending balances of the accounting equation for the law practice as shown in Learning Unit 1-1.

FIGURE 1.1 The Balance Sheet

	ASSETS	=	LIABILITIES	+ OWNER'S EQUITY
	Cash + Office Equipment	=	Accounts Payable	+ Mia Wong, Capital
ENDING BALANCES	$5,500 + $1,000	=	$300	+ $6,200

MIA WONG, ATTORNEY-AT-LAW
BALANCE SHEET
AUGUST 31, 200X

Assets		Liabilities and Owner's Equity	
Cash	$ 5 5 0 0 00	Liabilities	
Office Equipment	1 0 0 0 00	Accounts Payable	$ 3 0 0 00
		Owner's Equity	
		Mia Wong, Capital	6 2 0 0 00
		Total Liabilities and	
Total Assets	$ 6 5 0 0 00	Owner's Equity	$ 6 5 0 0 00

Note in Figure 1.1 that the assets owned by the law practice appear on the left-hand side and that the liabilities and owner's equity appear on the right-hand side. Both sides equal $6,500. This *balance* between left and right gives the balance sheet its name. In later chapters we look at other ways to set up a balance sheet.

Points to Remember in Preparing a Balance Sheet

The Heading The heading of the balance sheet provides the following information:

- The company name: Mia Wong, Attorney-at-Law
- The name of the statement: Balance Sheet
- The date for which the report is prepared: August 31, 200X

Use of the Dollar Sign Note that the dollar sign is not repeated each time a figure appears. As shown in Figure 1.2, the balance sheet for Mia Wong's law practice, it usually is placed to the left of each column's top figure and to the left of the column's total.

The three elements that make up a balance sheet are assets, liabilities, and owner's equity.

Distinguishing the Total When adding numbers down a column, use a single line before the total and a double line beneath it. A single line means that the numbers above it have been added or subtracted. A double line indicates a total. It is important to align the numbers in the column; many errors occur because these figures are not lined up. These rules are the same for all accounting reports.

The balance sheet gives Mia the information she needs to see the law firm's financial position before it opens for business. This information does not tell her, however, whether the firm will make a profit.

FIGURE 1.2 Partial Balance Sheet

MIA WONG, ATTORNEY-AT-LAW
BALANCE SHEET
AUGUST 31, 200X

Assets	
Cash	$ 5 5 0 0 00
Office Equipment	1 0 0 0 00
Total Assets	$ 6 5 0 0 00

A single line means the numbers above it have been added or subtracted.

A double line indicates a total.

LEARNING UNIT 1-2 REVIEW

AT THIS POINT you should be able to

- Define and state the purpose of a balance sheet.
- Identify and define the elements making up a balance sheet.
- Show the relationship between the accounting equation and the balance sheet.
- Prepare a balance sheet in proper form from information provided.

Self-Review Quiz 1-2

The date is November 30, 200X. Use the following information to prepare in proper form a balance sheet for Janning Company:

Accounts Payable	$40,000
Cash	18,000
A. Janning, Capital	9,000
Office Equipment	31,000

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Solution to Self-Review Quiz 1-2

FIGURE 1.3 Balance Sheet

JANNING COMPANY
BALANCE SHEET
NOVEMBER 30, 200X

Assets		Liabilities and Owner's Equity	
Cash	$18 0 0 0 00	Liabilities	
Office Equipment	31 0 0 0 00	Accounts Payable	$ 40 0 0 0 00
		Owner's Equity	
		A. Janning, Capital	9 0 0 0 00
		Total Liabilities and	
Total Assets	$4 9 0 0 0 00	Owner's Equity	$ 49 0 0 0 00

Accounting Cycle Tutorial

Capital does not mean cash. The capital amount is the owner's current investment of assets in the business.

NEED HELP?

Let's review first: A photo of your family as of a particular date is like a balance sheet. It gives you a history of your family as of a particular date. The balance sheet is a formal report that lists assets, liabilities, and owner's equity for a business as of a particular date.

Before making the report, identify whether each title is an asset, liability, or owner's equity. Accounts payable is a liability. Hopefully the business will be able to pay. Cash is an asset, or something of value owned by the business. A. Janning, Capital is owner's equity, or what the owner is supplying to the business.

The heading of a balance sheet answers three questions:

Who? Janning Company

What report? Balance Sheet

When? November 30, 200X

The left side of the balance sheet lists out the assets, cash, and office equipment.

The right side lists out who supplies the assets to the business: creditors (accounts payable) or the owner, A. Janning, Capital. Use single rules to add and double rules for totals. The sum of the left side must equal the sum of the right side.

Learning Unit 1-3 The Accounting Equation Expanded: Revenue, Expenses, and Withdrawals

LO3

As soon as Mia Wong's office opened, she began performing legal services for her clients and earning revenue for the business. At the same time, as a part of doing business, she incurred various expenses such as rent.

When Mia asked her accountant how these transactions fit into the accounting equation, she began by defining some terms.

Remember: Accounts receivable results from earning revenue even when cash is not yet received.

Record an expense when it is incurred, whether it is paid immediately or is to be paid later.

Revenue A service company earns **revenue** when it provides services to its clients. Mia's law firm earned revenue when she provided legal services to her clients for legal fees. When revenue is earned, owner's equity is increased. In effect, revenue is a subdivision of owner's equity.

Assets are increased. The increase is in the form of cash if the client pays right away. If the client promises to pay in the future, the increase is called **accounts receivable.** When revenue is earned, the transaction is recorded as an increase in revenue and an increase in assets (either as cash or as accounts receivable, depending on whether it was paid right away or will be paid in the future).

Expenses A business's **expenses** are the costs the company incurs in carrying on operations in its effort to create revenue. Expenses are also a subdivision of owner's equity; when expenses are incurred, they *decrease* owner's equity. Expenses can be paid for in cash or they can be charged.

Net Income/Net Loss When revenue totals more than expenses, **net income** is the result; when expenses total more than revenue, **net loss** is the result.

Withdrawals At some point Mia Wong may need to withdraw cash or other assets from the business to pay living or other personal expenses that do not relate to the business. We will record these transactions in an account called **withdrawals.** Sometimes this account is called the *owner's drawing account*. Withdrawals is a subdivision of owner's equity that records personal expenses not related to the business. Withdrawals decrease owner's equity (see Fig. 1.4 on the following page).

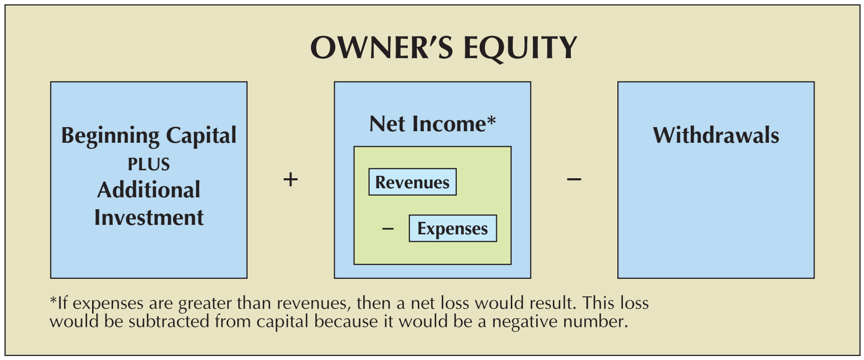
It is important to remember the difference between expenses and withdrawals. Expenses relate to business operations; withdrawals are the result of personal needs outside the normal operations of the business.

Now let's analyze the September transactions for Mia Wong's law firm using an **expanded accounting equation** that includes withdrawals, revenues, and expenses.

Expanded Accounting Equation

Transaction D Sept. 1–30: Provided legal services for cash, $2,000.

FIGURE 1.4 Owner's Equity



Transactions A, B, and C were discussed earlier, when the law office was being formed in August. See Learning Unit 1.1.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BALANCE FORWARD	$5,500		+ $1,000	= $ 300	+ $6,200			
	+2,000						**+ $2,000**	
ENDING BALANCE	$7,500		+ $1,000	= $ 300	+ $6,200		+ $2,000	

$8,500 = $8,500

In the law firm's first month of operation, a total of $2,000 in cash was received for legal services performed. In the accounting equation, the asset Cash is increased by $2,000. Revenue is also increased by $2,000, resulting in an increase in owner's equity.

A revenue column was added to the basic accounting equation. Amounts are recorded in the revenue column when they are earned. They are also recorded in the assets column under Cash and/or Accounts Receivable. Do not think of revenue as an asset. It is part of owner's equity. It is the revenue that creates an inward flow of cash and accounts receivable.

Transaction E Sept. 1–30: Provided legal services on account, $3,000.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BAL. FOR. TRANS.	$7,500		+ $ 1,000	= $ 300	+ $6,200		+ $2,000	
		+3,000					**+ $3,000**	
END. BAL.	$7,500	+ $3,000	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	

$11,500 = $11,500

Mia's law practice performed legal work on account for $3,000. The firm did not receive the cash for these earned legal fees; it accepted an unwritten promise from these clients that payment would be received in the future.

Transaction F Sept. 1–30: Received $900 cash as partial payment from previous services performed on account.

During September some of Mia's clients who had received services and promised to pay in the future decided to reduce what they owed the practice by making payment of $900. This decision is shown as follows on the expanded accounting equation:

Assets = Liabilities + Owner's Equity

Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses	
$7,500	+ $3,000	+ $ 1,000	= $ 300	+ $6,200		+ $5,000		**BAL. FOR. TRANS.**
+900	**−900**							
$8,400	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000		**END. BAL.**

$11,500 = $11,500

The law firm increased the asset Cash by $900 and reduced another asset, Accounts Receivable, by $900. The *total* of assets does not change. The right-hand side of the expanded accounting equation has not been touched because the total on the left-hand side of the equation has not changed. The revenue was recorded when it was earned, and the *same revenue cannot be recorded twice*. This transaction analyzes the situation *after* the revenue has been previously earned and recorded. Transaction F shows a shift in assets resulting in more cash and less accounts receivable.

Transaction G Sept. 1–30: Paid salaries expense, $700.

Assets = Liabilities + Owner's Equity

Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses	
$8,400	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000		**BAL. FOR. TRANS.**
−700							**+$700**	
$7,700	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $700	**END. BAL.**

$10,800 = $10,800

As expenses increase, they decrease owner's equity. This incurred expense of $700 reduces the cash by $700. Although the expense was paid, the total of our expenses to date has *increased* by $700. Keep in mind that owner's equity decreases as expenses increase, so the accounting equation remains in balance.

Transaction H Sept. 1–30: Paid rent expense, $400.

Assets = Liabilities + Owner's Equity

Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses	
$7,700	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $ 700	**BAL. FOR. TRANS.**
−400							**+400**	
$7,300	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $1,100	**END. BAL.**

$10,400 = $10,400

During September the practice incurred rent expenses of $400. This rent was not paid in advance; it was paid when it came due. The payment of rent reduces the asset Cash by $400 as well as increases the expenses of the firm, resulting in a decrease in owner's equity. The firm's expenses are now $1,100.

Transaction I Sept. 1–30: Incurred advertising expenses of $200, to be paid next month.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BAL. FOR. TRANS.	$7,300	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $1,100
				+200				**+200**
END. BAL.	$7,300	+ $2,100	+ $ 1,000	= $ 500	+ $6,200		+ $5,000	− $1,300
			$10,400	= $10,400				

Mia ran an ad in the local newspaper and incurred an expense of $200. This increase in expenses caused a corresponding decrease in owner's equity. Because Mia has not paid the newspaper for the advertising yet, she owes $200. Thus her liabilities (Accounts Payable) increase by $200. Eventually, when the bill comes in and is paid, both Cash and Accounts Payable will be decreased.

Transaction J Sept. 1–30: Mia withdrew $100 for personal use.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BAL. FOR. TRANS.	$7,300	+ $2,100	+ $ 1,000	= $ 500	+ $6,200		+ $5,000	− $1,300
	−100					**+$100**		
END. BAL.	$7,200	+ $2,100	+ $ 1,000	= $ 500	+ $6,200	− $100	+ $5,000	− $1,300
			$10,300	= $10,300				

By taking $100 for personal use, Mia *increased* her withdrawals from the business by $100 and decreased the asset Cash by $100. Note that as withdrawals increase, the owner's equity *decreases*. Keep in mind that a withdrawal is *not* a business expense. It is a subdivision of owner's equity that records money or other assets an owner withdraws from the business for *personal* use.

Subdivision of Owner's Equity Take a moment to review the subdivisions of owner's equity:

- As capital increases, owner's equity increases (see transaction A).
- As withdrawals increase, owner's equity decreases (see transaction J).
- As revenue increases, owner's equity increases (see transaction D).
- As expenses increase, owner's equity decreases (see transaction G).

Mia Wong's Expanded Accounting Equation The following is a summary of the expanded accounting equation for Mia Wong's law firm.

Mia Wong
Attorney-at-Law
Expanded Accounting Equation: A Summary

Assets			= Liabilities +	Owner's Equity				
Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses	
$6,000		+$200		+$6,200				A.
6,000		200		6,200				BALANCE
–500		+500						B.
5,500		700		6,200				BALANCE
		+300	+$300					C.
5,500		1,000	300	6,200				BALANCE
+2,000						+$2,000		D.
7,500		1,000	300	6,200		2,000		BALANCE
	+$3,000					+3,000		E.
7,500	3,000	1,000	300	6,200		5,000		BALANCE
+900	–900							F.
8,400	2,100	1,000	300	6,200		5,000		BALANCE
–700							+$700	G.
7,700	2,100	1,000	300	6,200		5,000	700	BALANCE
–400							+400	H.
7,300	2,100	1,000	300	6,200		5,000	1,100	BALANCE
			+200				+200	I.
7,300	2,100	1,000	500	6,200		5,000	1,300	BALANCE
–100					+$100			J.
$7,200	$2,100	$1,000	$500	$6,200	$100	$5,000	$1,300	END BALANCE

$10,300 = $10,300

LEARNING UNIT 1-3 REVIEW

AT THIS POINT you should be able to

- Define and explain the difference between revenue and expenses.
- Define and explain the difference between net income and net loss.
- Explain the subdivisions of owner's equity.
- Explain the effects of withdrawals, revenue, and expenses on owner's equity.
- Record transactions in an expanded accounting equation and balance the basic accounting equation as a means of checking the accuracy of your calculations.

For additional help go to www.pearsonhighered.com/slater

Self-Review Quiz 1-3

Record the following transactions into the expanded accounting equation for the Bing Company. Note that all titles have a beginning balance.

1. Received cash revenue, $4,000.
2. Billed customers for services rendered, $6,000.
3. Received a bill for telephone expenses (to be paid next month), $125.

4. Bob Bing withdrew cash for personal use, $500.
5. Received $1,000 from customers in partial payment for services performed in transaction 2.

Solution to Self-Review Quiz 1-3

	Assets					= Liabilities +		Owner's Equity								
	Cash	+	Accts. Rec.	+	Cleaning Equip.	=	Accts. Pay.	+	B. Bing, Capital	−	B. Bing, Withdr.	+	Revenue	−	Expenses
BEG. BALANCE	$10,000	+	$ 2,500	+	$ 6,500	=	$1,000	+	$11,800	−	$ 800	+	$ 9,000	−	$2,000
1.	**+4,000**												**+4,000**		
BALANCE	14,000	+	2,500	+	6,500	=	1,000	+	11,800	−	800	+	13,000	−	2,000
2.			+6,000										+6,000		
BALANCE	14,000	+	8,500	+	6,500	=	1,000	+	11,800	−	800	+	19,000	−	2,000
3.							+125								+125
BALANCE	14,000	+	8,500	+	6,500	=	1,125	+	11,800	−	800	+	19,000	−	2,125
4.	**–500**										**+500**				
BALANCE	13,500	+	8,500	+	6,500	=	1,125	+	11,800	−	1,300	+	19,000	−	2,125
5.	**+1,000**		**–1,000**												
END. BALANCE	$14,500	+	$ 7,500	+	$ 6,500	=	$1,125	+	$11,800	−	$1,300	+	$19,000	−	$2,125

$28,500 = $28,500

NEED HELP?

Let's review first: You only record revenue when it is earned. What can the business get? Cash and/or promises from customers called Accounts Receivable. Revenue is not an asset but does provide an inward flow of assets into the business. Revenue is part of owner's equity. Think of expenses as always increasing in a business. The end result will be a decrease in owner's equity. Expenses are recorded when they happen and can be paid for by cash or charged as Accounts Payable.

Withdrawals work just like expenses, but they represent personal withdrawals by the owner. Expenses and withdrawals are not recorded together. Each has a separate title.

Transaction 1: The company has done the work. It now records revenue of $4,000 in the revenue column (we only put numbers in this column when we do the work). This time the inward flow from the revenue is all in the form of cash of $4,000.

Transaction 2: This time the company does the work but is not getting the cash. It is receiving promises that it will be paid in the future. You record the $6,000 in the revenue column because you did the work. The inward flow from this revenue is not cash but promises called Accounts Receivable. Thus, the Accounts Receivable column is increased by $6,000.

Transaction 3: An expense has happened and should be recorded whether money is paid or not. The expenses for telephone have

INCREASED by $125, resulting in the total expenses rising to $2,125. As expenses in a business rise, the end result is a reduction in owner's equity.

Since the expense was charged, the $125 is recorded under Accounts Payable because hopefully the expense will be paid in the future. At this point this telephone expense has created a liability. Remember that an expense is not a liability.

Transaction 4: This transaction relates to a personal transaction and does not affect any expenses in the business. Bob Bing takes $500 cash from the business. Think of Bob as gaining the $500, but in reality his owner's rights will be reduced. This is shown by a $500 gain under withdrawals, which now results in a total of $1,300 (a reduction to owner's equity) and a decrease to cash. Note that expenses are not affected since this is a personal transaction.

Transaction 5: No new work is earned, so we do not record any new revenue. Here customers are paying part of what they owe. The result is that company cash increased by $1,000 and Accounts Receivable is reduced by $1,000. This is a shift in assets: more cash, less accounts receivable.

Summary: Note the four subdivisions of owner's equity: Capital, Withdrawals, Revenues, and Expenses. As capital and revenue increases, owner's equity will increase. As expenses and withdrawals increase, owner's equity will decrease. Revenue is not an asset. Rather, it provides assets in the form of cash and/or accounts receivable. Only record revenue when work is done. Only record expenses when they happen, regardless whether cash is received.

Learning Unit 1-4 Preparing Financial Statements

LO4

Mia Wong would like to be able to find out whether her firm is making a profit, so she asks her accountant whether he can measure the firm's financial performance on a monthly basis. Her accountant replies that a number of financial statements that he can prepare, such as the income statement, will show Mia how well the law firm has performed over a specific period of time. The accountant can use the information in the income statement to prepare other reports.

The Income Statement

An **income statement** is an accounting statement that shows business results in terms of revenue and expenses. If revenues are greater than expenses, the report shows net income. If expenses are greater than revenues, the report shows net loss. An income statement can cover 1, 3, 6, or 12 months. It cannot cover more than one year. The statement shows the result of all revenues and expenses throughout the entire period and not just as of a specific date. The income statement for Mia Wong's law firm is shown in Figure 1.5 on the following page.

Points to Remember in Preparing an Income Statement

Heading The heading of an income statement tells the same three things as all other accounting statements: the company's name, the name of the statement, and the period of time the statement covers.

The Setup As you can see on the income statement, the inside column of numbers ($700, $400, and $200) is used to subtotal all expenses ($1,300) before subtracting them from revenue ($5,000 − $1,300 = $3,700).

The income statement is prepared from data found in the revenue and expense columns of the expanded accounting equation. The inside column of numbers ($700, $400, $200) is used to subtotal all expenses ($1,300) before subtracting from revenue.

FIGURE 1.5 The Income Statement

Software programs may call this statement a profit and loss statement or an earnings statement.

MIA WONG, ATTORNEY-AT-LAW INCOME STATEMENT FOR MONTH ENDED SEPTEMBER 30, 200X		
Revenue:		
Legal Fees		$ 5000 00
Operating Expenses:		
Salaries Expense	$ 700 00	
Rent Expense	400 00	
Advertising Expense	200 00	
Total Operating Expenses		1300 00
Net Income		$ 3700 00

Operating expenses may be listed in alphabetical order, in order of largest amounts to smallest, or in a set order established by the accountant.

The Statement of Owner's Equity

If this statement of owner's equity is omitted, the information will be included in the owner's equity section of the balance sheet.

As we said, the income statement is a business statement that shows business results in terms of revenue and expenses, but how does net income or net loss affect owner's equity? To find out, we have to look at a second type of statement, the **statement of owner's equity.**

The statement of owner's equity shows for a certain period of time what changes occurred in Mia Wong, Capital. The statement of owner's equity is shown in Figure 1.6.

The capital of Mia Wong can be

Increased by: Owner Investment
Net Income (Revenue − Expenses) and Revenue Greater Than Expenses
Decreased by: Owner Withdrawals
Net Loss (Revenue − Expenses) and Expenses Greater Than Revenue

Remember, a withdrawal is *not* a business expense and thus is not involved in the calculation of net income or net loss on the income statement. It appears on the statement of owner's equity. The statement of owner's equity summarizes the effects of all the subdivisions of owner's equity (revenue, expenses, withdrawals) on beginning capital. The ending capital figure ($9,800) will be the beginning figure in the next statement of owner's equity.

Suppose Mia's law firm had operated at a loss in the month of September. Suppose instead of net income, a $400 net loss occurred and an additional investment of $700 was made on September 15. Figure 1.7 shows how the statement would look with this net loss and additional investment.

FIGURE 1.6 Statement of Owner's Equity—Net Income

This statement, called a statement of retained earnings in Peachtree, is not available as a report in QuickBooks.

MIA WONG, ATTORNEY-AT-LAW STATEMENT OF OWNER'S EQUITY FOR MONTH ENDED SEPTEMBER 30, 200X		
Mia Wong, Capital, September 1, 200X		$ 6200 00
Net Income for September	$ 3700 00	
Less Withdrawals for September	100 00	
Increase in Capital		3600 00
Mia Wong, Capital, September 30, 200X		$ 9800 00

Comes from Income Statement

FIGURE 1.7 Statement of Owner's Equity—Net Loss

MIA WONG, ATTORNEY-AT-LAW STATEMENT OF OWNER'S EQUITY FOR MONTH ENDED SEPTEMBER 30, 200X		
Mia Wong, Capital, September 1, 200X		$ 6,200.00
Additional Investment, September 15, 200X		700.00
Total Investment for September*		$ 6,900.00
Less: Net Loss for September	$ 400.00	
Withdrawals for September	100.00	
Decrease in Capital		500.00
Mia Wong, Capital, September 30, 200X		$ 6,400.00

*Beginning capital and additional investments.

The Balance Sheet

Now let's look at how to prepare a balance sheet from the expanded accounting equation (see Fig. 1.8). As you can see, the asset accounts (cash, accounts receivable, and office equipment) appear on the left side of the balance sheet.

Accounts payable and Mia Wong, Capital appear on the right side. Notice that the $9,800 of capital can be calculated within the accounting equation or can be read from the statement of owner's equity.

FIGURE 1.8 The Accounting Equation and the Balance Sheet

MIA WONG, ATTORNEY-AT-LAW BALANCE SHEET SEPTEMBER 30, 200X			
Assets		Liabilities and Owner's Equity	
Cash	$ 7,200.00	Liabilities	
Accounts Receivable	2,100.00	Accounts Payable	$ 500.00
Office Equipment	1,000.00	Owner's Equity	
		Mia Wong, Capital	9,800.00
		Total Liabilities and	
Total Assets	$10,300.00	Owner's Equity	$10,300.00

$9,800 comes from ending capital figure on statement of owner's equity

	ASSETS			=	LIABILITIES	+	OWNER'S EQUITY			
	Cash	+ Accts. Rec.	+ Office Equip.	=	Accts. Pay.		+ M. Wong, Capital	– M. Wong, Withdr.	+ Revenue	– Expenses
END. BAL.	$7,200	+$2,100	+ $1,000	=	$500		+ $6,200	– $100	+ $5,000	– $1,300
	$10,300				$10,300					

Net income is reported separately from capital on the balance sheet in the equity section in both QuickBooks and Peachtree.

Main Elements of the Income Statement, the Statement of Owner's Equity, and the Balance Sheet

In this chapter we have discussed three financial statements: the income statement, the statement of owner's equity, and the balance sheet. A fourth statement, called the statement of cash flows, will not be covered at this time. Let us review what elements of the expanded accounting equation go into each statement and the usual order in which the statements are prepared. Figure 1.8 presents a diagram of the accounting equation and the balance sheet. Table 1.3 on the following page summarizes the following points:

- The income statement is prepared first; it includes revenues and expenses and shows net income or net loss. This net income or net loss is used to update the next statement, the statement of owner's equity.

TABLE 1.3 What Goes on Each Financial Statement

	Income Statement	Statement of Owner's Equity	Balance Sheet
Assets			X
Liabilities			X
Capital* (beg.)		X	
Capital (end)		X	X
Withdrawals		X	
Revenues	X		
Expenses	X		

**Note:* Additional Investments go on the statement of owner's equity.

- The statement of owner's equity is prepared second; it includes beginning capital and any additional investments, the net income or net loss shown on the income statement, withdrawals, and the total, which is the **ending capital.** The balance in Capital comes from the statement of owner's equity.
- The balance sheet is prepared last; it includes the final balances of each of the elements listed in the accounting equation under Assets and Liabilities. The balance in Capital comes from the statement of owner's equity.

LEARNING UNIT 1-4 REVIEW

AT THIS POINT you should be able to

- Define and state the purpose of the income statement, the statement of owner's equity, and the balance sheet.
- Discuss why the income statement should be prepared first.
- Show what happens on a statement of owner's equity when a net loss occurs.
- Compare and contrast these three financial statements.
- Calculate a new figure for capital on the statement of owner's equity and the balance sheet.

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Self-Review Quiz 1-4

From the balances listed next for Rusty Realty prepare the following:

1. Income statement for the month ended November 30, 200X.
2. Statement of owner's equity for the month ended November 30, 200X.
3. Balances as of November 30, 200X.

Cash	$4,000	R. Rusty, Capital	
Accounts Receivable	1,370	November 1, 200X	$5,000
Store Furniture	1,490	R. Rusty, Withdrawals	100
Accounts Payable	900	Commissions Earned	1,500
		Rent Expense	200
		Advertising Expense	150
		Salaries Expense	90

Solution to Self-Review Quiz 1-4

FIGURE 1.9 Financial Reports

RUSTY REALTY
INCOME STATEMENT
FOR MONTH ENDED NOVEMBER 30, 200X

Revenue:		
Commissions Earned		$ 1 5 0 0 00
Operating Expenses:		
Rent Expense	$ 2 0 0 00	
Advertising Expense	1 5 0 00	
Salaries Expense	9 0 00	
Total Operating Expenses		4 4 0 00
Net Income		$ 1 0 6 0 00

Subtotal Columns

RUSTY REALTY
STATEMENT OF OWNER'S EQUITY
FOR MONTH ENDED NOVEMBER 30, 200X

R. Rusty, Capital, November 1, 200X		$ 5 0 0 0 00
Net Income for November	$ 1 0 6 0 00	
Less Withdrawals for November	1 0 0 00	
Increase in Capital		9 6 0 00
R. Rusty, Capital, November 30, 200X		$ 5 9 6 0 00

RUSTY REALTY
BALANCE SHEET
NOVEMBER 30, 200X

Assets		Liabilities and Owner's Equity	
Cash	$ 4 0 0 0 00	Liabilities	
Accounts Receivable	1 3 7 0 00	Accounts Payable	$ 9 0 00
Store Furniture	1 4 9 0 00		
		Owner's Equity	
		R. Rusty, Capital	5 9 6 0 00
		Total Liabilities and	
Total Assets	$ 6 8 6 0 00	Owner's Equity	$ 6 8 6 0 00

NEED HELP?

Let's review first: The first formal report is the income statement, which is made up of only revenues and expenses. This report shows how a company is performing for a specific period of time. The second report is the statement of the owner's equity. This report shows how capital has changed from its beginning balance. The net income is added to the beginning balance less any personal withdrawals resulting in a new figure for capital, which will also be placed in the balance sheet. This third report, the balance sheet, is made up of assets, liabilities, and the new figure for capital. The balance sheet shows the history of the company as of a particular date.

The Income Statement: Commissions earned is the revenue for Rusty Realty. It is listed to the right since it is the only revenue. The inside column is used for a subtotal if there is more than one revenue.

Rent, Advertising, and Salaries are expenses that are listed on the income statement. Note that we use the inside column to subtotal them and then list the final figure as total operating expenses of $440 in the right column. The difference between revenue ($1,500) and the total operating expenses ($440) results in a net income of $1,060. Keep in mind that net income is not cash. Remember that some revenue may not have resulted in cash and some of the expenses may not have been paid for in cash.

Statement of Owner's Equity: The beginning balance of Rusty, Capital is $5,000. We place this to the right because it is one number. We then use the inside column to add net income from the income statement ($1,060) and subtract any withdrawals ($100) to get an increase in capital of $960, which is placed in the right column. This figure is then added to beginning capital to arrive at Rusty, Capital (ending) of $5,960.

Balance Sheet: All the assets are listed on the left (cash, accounts receivable, and store furniture), for a total of $6,860. The liability of $900 for accounts payable is listed on the right and will be added to the new figure for Rusty, Capital of $5,960 from the statement of owner's equity.

Summary: The income statement lists out revenue and expenses. No withdrawals are found on this report. The statement of owner's equity will show how capital changes by net income, net loss, and/or withdrawals. The balance shows the new history of the company's assets, liabilities, and a new figure for capital.

CHAPTER ASSIGNMENTS

MyAccountingLab

All Classroom Demonstration Exercises, Exercises, Problems, and the Continuing Problem in this chapter can be found within MyAccountingLab, an online homework and practice environment. Your instructor may ask you to complete this material using MyAccountingLab.

DEMONSTRATION PROBLEM

Michael Brown opened his law office on June 1, 200X. During the first month of operations, Michael conducted the following transactions:

1. Invested $6,000 in cash into the law practice.
2. Paid $600 for office equipment.
3. Purchased additional office equipment on account, $1,000.
4. Received cash for performing legal services for clients, $2,000.
5. Paid salaries, $800.
6. Performed legal services for clients on account, $1,000.

7. Paid rent, $1,200.
8. Withdrew $500 from his law practice for personal use.
9. Received $500 from customers in partial payment for legal services performed, transaction 6.

ASSIGNMENT

Record these transactions in the expanded accounting equation.
Prepare the financial statements at June 30 for Michael Brown, Attorney-at-Law.

Solution to Demonstration Problem

	Assets			= Liabilities +	Owner's Equity			
A.	**Cash**	**+ Accts. Rec.**	**+ Office Equip.**	**= Accounts Payable**	**+ M. Brown, Capital**	**− M. Brown, Withdr.**	**+ Legal Fees**	**− Expenses**
1.	**+$6,000**				**+$6,000**			
BAL.	6,000			=	6,000			
2.	**–600**		**+$600**					
BAL.	5,400		+ 600 =		6,000			
3.			**+1,000**	**+$1,000**				
BAL.	5,400		+ 1,600 =	1,000	+ 6,000			
4.	**+2,000**						**+$2,000**	
BAL.	7,400		+ 1,600 =	1,000	+ 6,000		+ 2,000	
5.	**–800**							**+$800**
BAL.	6,600		+ 1,600 =	1,000	+ 6,000		+ 2,000 −	800
6.		**+$1,000**					**+1,000**	
BAL.	6,600 +	1,000 +	1,600 =	1,000	+ 6,000		+ 3,000 −	800
7.	**–1,200**							**+1,200**
BAL.	5,400 +	1,000 +	1,600 =	1,000	+ 6,000		+ 3,000 −	2,000
8.	**–500**					**+$500**		
BAL.	4,900 +	1,000 +	1,600 =	1,000	+ 6,000	− 500	+ 3,000 −	2,000
9.	**+500**	**–500**						
END. BAL.	$5,400 +	$ 500 +	$1,600 =	$1,000	+ $6,000	− $500	+ $3,000 −	$2,000

$7,500 = $7,500

Solution Tips to Expanded Accounting Equation

- **Transaction 1:** The business increased its Cash by $6,000. Owner's Equity (capital) increased when Michael supplied the cash to the business.
- **Transaction 2:** A shift in assets occurred when the equipment was purchased. The business lowered its Cash by $600, and a new column—Office Equipment—was increased for the $600 of equipment that was bought. The amount of capital is not touched because the owner did not supply any new funds.
- **Transaction 3:** When creditors supply $1,000 of additional equipment, the business Accounts Payable shows the debt. The business had increased what it *owes* the creditors.
- **Transaction 4:** Legal Fees, a subdivision of Owner's Equity, is increased when the law firm provides a service even if no money is received. The service provides an inward flow of $2,000 to Cash, an asset. Remember that Legal Fees are *not* an asset. As Legal Fees increase, Owner's Equity increases.
- **Transaction 5:** The salary paid by Michael shows an $800 increase in Expenses and a corresponding decrease in Owner's Equity as well as a decrease in Cash.

- **Transaction 6:** Michael did the work and earned the $1,000. That $1,000 is recorded as revenue. This time the Legal Fees create an inward flow of assets called Accounts Receivable for $1,000. Remember that Legal Fees are *not* an asset. They are a subdivision of Owner's Equity.
- **Transaction 7:** The $1,200 rent expense reduces Owner's Equity as well as Cash.
- **Transaction 8:** Withdrawals are for personal use. Here the business decreases Cash by $500 while Michael's withdrawals increase $500. Withdrawals decrease the Owner's Equity.
- **Transaction 9:** This transaction does not reflect new revenue in the form of Legal Fees. It is only a shift in assets: more Cash and less Accounts Receivable.

Solution Tips to Financial Statements

B-1. The income statement lists only revenues and expenses for a period of time. The inside column is for subtotaling. Withdrawals are not listed here.

B-2. The statement of owner's equity takes the net income figure of $1,000 and adds it to beginning capital less any withdrawals. This new capital figure of $6,500 will go on the balance sheet. This statement shows changes in capital for a period of time.

B-3. The $5,400, $500, $1,600, and $1,000 came from the totals of the expanded accounting equation. The capital figure of $6,500 came from the statement of owner's equity. This balance sheet reports assets, liabilities, and a new figure for capital at a specific date.

B-1.

MICHAEL BROWN, ATTORNEY-AT-LAW
INCOME STATEMENT
FOR MONTH ENDED JUNE 30, 200X

Revenue:		
Legal Fees		$3,000
Operating Expenses:		
Salaries Expense	$ 800	
Rent Expense	1,200	
Total Operating Expenses		2,000
Net Income		$1,000

B-2.

MICHAEL BROWN, ATTORNEY-AT-LAW
STATEMENT OF OWNER'S EQUITY
FOR MONTH ENDED JUNE 30, 200X

Michael Brown, Capital, June 1, 200X		$6,000
Net income for June	$1,000	
Less withdrawls for June	500	
Increase in Capital		500
Michael Brown, Capital, June 30, 200X		$6,500

B-3.

MICHAEL BROWN, ATTORNEY-AT-LAW
BALANCE SHEET
JUNE 30, 200X

Assets		**Liabilities and Owner's Equity**	
Cash	$5,400	Liabilities	
Accounts Receivable	500	Accounts Payable	$1,000
Office Equipment	1,600	Owner's Equity	
		M. Brown, Capital	$6,500
Total Assets	$7,500	Total Liabilities and Owner's Equity	$7,500

SUMMARY OF KEY POINTS

LEARNING UNIT 1-1

1. The Sarbanes-Oxley rule helps prevent fraud at trading companies.
2. The functions of accounting involve analyzing, recording, classifying, summarizing, reporting, and interpreting financial information.
3. A sole proprietorship is a business owned by one person. A partnership is a business owned by two or more persons. A corporation is a business owned by stockholders. All forms of business organizations are found in Internet businesses.
4. Bookkeeping is the recording part of accounting.
5. The computer is a tool to use in the accounting process.
6. Assets = Liabilities + Owner's Equity is the basic accounting equation that aids in analyzing business transactions.
7. Liabilities represent amounts owed to creditors, whereas capital represents what is invested by the owner.
8. Capital does not mean cash. Capital is the owner's current investment. The owner could have invested equipment that was purchased before the new business was started.
9. In a shift of assets the composition of assets changes but the total of assets does not change. For example, if a bill is paid by a customer, the firm increases Cash (an asset) but decreases Accounts Receivable (an asset), so no overall increase in assets occurs; total assets remain the same. When you borrow money from a bank, you have an increase in cash (an asset) and an increase in liabilities; overall, assets increase rather than simply shift.

LEARNING UNIT 1-2

1. The balance sheet is a statement written as of a particular date. It lists the assets, liabilities, and owner's equity of a business. The heading of the balance sheet answers the questions *who, what,* and *when* (as of a specific date).
2. The balance sheet is a formal statement of a financial position.

LEARNING UNIT 1-3

1. Revenue generates an inward flow of assets. Expenses generate an outward flow of assets or a potential outward flow. Revenue and expenses are subdivisions of owner's equity. Revenue is not an asset.
2. When revenue totals more than expenses net income is the result; when expenses total more than revenue net loss is the result.
3. Owner's equity can be subdivided into four elements: capital, withdrawals, revenue, and expenses.
4. Withdrawals decrease owner's equity, revenue increases owner's equity, and expenses decrease owner's equity. A withdrawal is not a business expense; it is for personal use.

LEARNING UNIT 1-4

1. The income statement is a statement written for a specific period of time that lists earned revenue and expenses incurred to produce the earned revenue. The net income or net loss will be used in the statement of owner's equity.
2. The statement of owner's equity reveals the causes of a change in capital. This statement lists any investments, net income (or net loss), and withdrawals. The ending figure for capital will be used on the balance sheet.
3. The balance sheet uses the ending balances of assets and liabilities from the accounting equation and the capital from the statement of owner's equity.
4. The income statement should be prepared first because the information on it about net income or net loss is used to prepare the statement of owner's equity, which in turn provides information about capital for the balance sheet. In this way one statement builds upon the next, beginning with the income statement.

KEY TERMS

Accounting A system that measures the business's activities in financial terms, provides written reports and financial statements about those activities, and communicates these reports to decision makers and others.

Accounts payable Amounts owed to creditors that result from the purchase of goods or services on account—a liability.

Accounts receivable An asset that indicates amounts owed by customers.

Assets Properties (resources) of value owned by a business (cash, supplies, equipment, land).

Balance sheet A statement, as of a particular date, that shows the amount of assets owned by a business as well as the amount of claims (liabilities and owner's equity) against these assets.

Basic accounting equation Assets = Liabilities + Owner's Equity.

Bookkeeping The recording function of the accounting process.

Capital The owner's investment of equity in the company.

Corporation A type of business organization that is owned by stockholders. Stockholders usually are not personally liable for the corporation's debts.

Creditor Someone who has a claim to assets.

Ending capital Beginning Capital + Additional Investments + Net Income − Withdrawals = Ending Capital. Or: Beginning Capital + Additional Investments − Net Loss − Withdrawals = Ending Capital.

Equities The interest or financial claim of creditors (liabilities) and owners (owner's equity) who supply the assets to a firm.

Expanded accounting equation Assets = Liabilities + Capital − Withdrawals + Revenue − Expenses.

Expense A cost incurred in running a business by consuming goods or services in producing revenue; a subdivision of owner's equity. When expenses increase, there is a decrease in owner's equity.

Generally accepted accounting principles (GAAP) The procedures and guidelines that must be followed during the accounting process.

Income statement An accounting statement that details the performance of a firm (revenue minus expenses) for a specific period of time.

Liabilities Obligations that come due in the future. Liabilities result in increasing the financial rights or claims of creditors to assets.

Manufacturer Business that makes a product and sells it to its customers.

Merchandise company Business that buys a product from a manufacturing company to sell to its customers.

Net income When revenue totals more than expenses, the result is net income.

Net loss When expenses total more than revenue, the result is net loss.

Owner's equity Rights or financial claims to the assets of a business (in the accounting equation, assets minus liabilities).

Partnership A form of business organization that has at least two owners. The partners usually are personally liable for the partnership's debts.

Revenue An amount earned by performing services for customers or selling goods to customers; it can be in the form of cash or accounts receivable. A subdivision of owner's equity: As revenue increases, owner's equity increases.

Service company Business that provides a service.

Shift in assets A shift that occurs when the composition of the assets has changed but the total of the assets remains the same.

Sole proprietorship A type of business ownership that has one owner. The owner is personally liable for paying the business's debts.

Statement of financial position Another name for a balance sheet.

Statement of owner's equity A financial statement that reveals the change in capital. The ending figure for capital is then placed on the balance sheet.

Supplies One type of asset acquired by a firm; it has a much shorter life than equipment.

Withdrawals A subdivision of owner's equity that records money or other assets an owner withdraws from a business for personal use.

BLUEPRINT: FINANCIAL STATEMENTS

1 Income Statement

Measuring performance

Revenue:		XXX
Operating Expenses	XX	
Other Expenses	XX	XXX
Net Income		XXX

2 Statement of Owner's Equity

Calculating new figure for capital

Beginning Capital		XXX
Additional Investments		XXX
Total Investments		XXX
Net Income (or loss)	XXX	
Less Withdrawals	XXX	
Increase in Capital (or decrease)		XXX
Ending Capital		XXX

3 Balance Sheet

Where do we now stand

Assets		Liabilities and Owner's Equity	
	XXX	Liabilities	XXX
	XXX	Owner's Equity	
	XXX	Ending Capital	XXX
Total Assets	XXX	Total Liab. + OE	XXX

QUESTIONS, CLASSROOM DEMONSTRATION EXERCISES, EXERCISES, AND PROBLEMS

Discussion and Critical Thinking Questions/Ethical Case

1. What are the functions of accounting?
2. Define, compare, and contrast sole proprietorships, partnerships, and corporations.
3. How are businesses classified?
4. What is the relationship of bookkeeping to accounting?
5. List the three elements of the basic accounting equation.
6. Define capital.
7. The total of the left-hand side of the accounting equation must equal the total of the right-hand side. True or false? Please explain.
8. A balance sheet tells a company where it is going and how well it performs. True or false? Please explain.
9. Revenue is an asset. True or false? Please explain.
10. Owner's equity is subdivided into what categories?
11. A withdrawal is a business expense. True or false? Please explain.
12. As expenses increase they cause owner's equity to increase. Defend or reject.
13. What does an income statement show?
14. The statement of owner's equity only calculates ending withdrawals. True or false? Please explain.