

CHAPTER 1

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ACCOUNTING IN ACTION

OVERVIEW

You and every other member of society depend on information to function efficiently and effectively. For example, people who invest in business enterprises use economic information to guide their decisions about future financial possibilities. Information about the effects of past actions is accumulated to serve as an aid in making better decisions in the future.

As a financial information system, accounting is the process of identifying, recording, and communicating the economic events of an organization. In this chapter, we: (1) introduce the subject of accounting and GAAP (generally accepted accounting principles), (2) discuss the basic accounting equation and the effects of transactions on its elements, and (3) examine the composition of the four general purpose financial statements required for business enterprises.

SUMMARY OF STUDY OBJECTIVES

1. **Explain the meaning of accounting.** Accounting is the process of identifying, recording, and communicating the economic events of an organization (business or non-business) to interested users of the information.
2. **Identify the users and uses of accounting.** The major users and uses of accounting are: (a) Management uses accounting information to plan, control, and evaluate business operations. (b) Investors (owners) judge the wisdom of buying, holding, or selling their financial interest on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money to particular businesses on the basis of the accounting information obtained about those businesses. Other groups with an indirect interest are taxing authorities, regulatory agencies, customers, labour unions, and economic planners.
3. **Understand why ethics is a fundamental business concept.** Ethics are the standards of conduct by which one's actions—both personal and business—are judged as right or wrong. If you cannot depend on the honesty of the individuals with whom you deal, effective communication and economic activity would be impossible and information would have no credibility.

4. **Explain the meaning of generally accepted accounting principles and the cost principle.** Generally accepted accounting principles are a set of standards used to prepare and report accountants' information. One important principle is the cost principle, which states that assets should be recorded at their historical (or original) cost.
5. **Explain the meaning of the going concern, monetary unit, and the economic entity assumptions.** The going concern assumption presumes that a business will continue operations for sufficient time to utilize its assets for their intended purpose and fulfill its commitments. The monetary unit assumption requires that only transaction data capable of being expressed in terms of money be included in the accounting records of the economic entity. The economic entity assumption states that economic events can be identified with a particular unit of accountability.
6. **State the basic accounting equation and explain the meaning of assets, liabilities, and owner's equity.** The basic accounting equation is:

$$\text{ASSETS} = \text{LIABILITIES} + \text{OWNER'S EQUITY}$$

Assets are resources owned by a business. Liabilities are creditorship claims on total assets. Owner's equity is the ownership claim on total assets.

7. **Analyse the effect of business transactions on the basic accounting equation.** Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset is increased, there must be a corresponding: (1) decrease in another asset, or (2) increase in a liability, and/or (3) increase in owner's equity.
8. **Distinguish between an income statement, statement of owner's equity, balance sheet, and statement of cash flows.** An income statement presents the revenues and expenses of a company for a specified period of time. A statement of owner's equity summarizes the changes in owner's equity that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and owner's equity of a business at a specific date. A statement of cash flows summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

TIPS ON CHAPTER TOPICS

TIP: Accounting is the language of business. Thus, the more you learn and understand about accounting and its usefulness, the better you will be able to succeed in any business endeavour, regardless of what your major field of study and job title are.

TIP: **Transactions** are the economic events of an entity recorded by accountants. Some events (happenings of consequence to an entity) are not measurable in terms of money and thus do not get recorded in the accounting records. Hiring employees, placing an order for supplies, greeting a customer and quoting prices for products are examples of activities that do not by themselves constitute transactions. When an event is identified as a transaction, it must be measured in dollar terms, and then recorded.

TIP: When you encounter a transaction, always analyse it in terms of its effects on the elements of the basic accounting equation (or **balance sheet equation**). For your analysis to be complete, it must maintain balance in the basic accounting equation. The **basic accounting equation** is as follows:

LEFT SIDE = RIGHT SIDE

ASSETS = LIABILITIES + OWNER'S EQUITY

Assets are economic resources. Liabilities and owner's equity are sources of resources; liabilities are creditor sources, and owner's equity represents owner sources (owner investments and undistributed profits).

TIP: The balance of liabilities and the balance of owner's equity at a point in time simply serve as scorecards of the total amounts of right side assets which have come about from creditor sources (liabilities) and owner sources (owner's equity). Thus, you can **not** determine the amount of cash (or any other specific asset) held by an entity by looking at the balance of owner's equity or liabilities. You must look at the listing of individual assets on the balance sheet to determine the amount of cash owned.

TIP: The owner's equity of a business, particularly a proprietorship (a business with one owner), is often called capital.

TIP: A **revenue type transaction** will always cause an increase in owner's equity. In addition, it will cause either an increase in assets or a decrease in liabilities (the former is the more common effect). An **expense type transaction** will always cause a decrease in owner's equity. In addition, it will cause either a decrease in assets or an increase in liabilities (the former is the more common effect).

TIP: The **cost principle** is often called the **historical cost principle**. Because of this principle, we typically report the cost of assets held, not their market values. Generally, the balance sheet does not purport to reflect market values.

TIP: Like any other discipline, accounting has its own vocabulary. In order for you to be able to understand what you read in subsequent chapters of this book, it is imperative that you master the new terms explained in this chapter. If you are not thoroughly familiar with the basic concepts used to explain more advanced material, you will likely have an erroneous interpretation of that later material. For each chapter in your text, make it a habit to study the glossary until you master the new terms being introduced. You will find Exercises in this book on Accounting terminology.

TIP: Accounting assumptions and principles are often referred to as accounting concepts.

TIP: Generally, accounting is based on completed transactions. As a result, salaries which have been earned by employees (whether paid or not) must be accounted for presently, however, salaries to be earned by employees and paid by the entity in future periods are not reflected in the entity's statements until the future period in which they are incurred.

TIP: Read the Preface and How to Study Accounting. These precede Chapter 1 of this self-study volume.

EXERCISE 1-1

Purpose: (S.O. 6, 7) This exercise will test your understanding of the components of the basic accounting equation.

Instructions

A list of **independent** situations appears below. Answer each question posed.

1. The total assets of The Thompson River Equipment Company at December 31, 2000 are \$380,000 and its total liabilities are \$150,000 at that same date. **Question:** What is the amount of The Thompson River Equipment Company's total owner's equity at December 31, 2000?

Answer: _____

2. The total assets of Chen Optical Company are \$400,000 at December 31, 2000, and its total owner's equity is \$280,000 at the same date. **Question:** What is the amount of Chen Optical Company's total liabilities at December 31, 2000?

Answer: _____

3. The total liabilities of Murphy's Farm Products are \$128,000 at December 31, 2000. Total owner's equity for the company is \$220,000 at that same date. **Question:** What is the amount of total assets for the company at December 31, 2000?

Answer: _____

4. The total liabilities of The Cellular Seven.com Company are \$80,000. The total assets of the company are three times the amount of its total liabilities. **Question:** What is the amount of The Cellular Seven.com Company's total owner's equity?

Answer: _____

5. At January 1, 2000, The Endless Energy Company had total assets of \$600,000 and total liabilities of \$340,000. During the calendar year of 2000, total assets increased \$80,000, and total liabilities decreased \$30,000. **Question 1:** What was the change in owner's equity during 2000?

Answer 1: _____

Question 2: What was the amount of owner's equity at December 31, 2000?

Answer 2: _____

6. At January 1, 2000, Sunlight Company had total assets of \$500,000 and total owner's equity of \$280,000. During 2000, total assets decreased \$40,000, and total liabilities decreased \$22,000. **Question 1:** What was the amount of total liabilities at January 1, 2000?

Answer 1: _____

Question 2: What was the change during 2000 in total owner's equity?

Answer 2: _____

Question 3: What was the total owner's equity at December 31, 2000?

Answer 3: _____

SOLUTION TO EXERCISE 1-1

Approach: Write down the basic accounting equation:

ASSETS = LIABILITIES + OWNER'S EQUITY or A = L + OE or LEFT SIDE = RIGHT SIDE
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Fill in the amounts given and use your knowledge of algebra to solve for any unknown.

Explanation:

- Assets = Liabilities + Owner's Equity
 $\$380,000 = \$150,000 + OE$
 $\$380,000 - \$150,000 = OE$
 $\$230,000 = OE$
 $\$230,000$ = Owner's Equity

TIP: Recall that algebraic rules require the change in a number's sign when moved to the other side of the equals sign. Thus, a positive \$150,000 becomes a negative \$150,000 when moved from the right side of the equation to the left side of the equation.

- Assets = Liabilities + Owner's Equity
 $\$400,000 = L + \$280,000$
 $\$400,000 - \$280,000 = L$
 $\$120,000 = L$
 $\$120,000$ = Liabilities

- Assets = Liabilities + Owner's Equity
 $A = \$128,000 + \$220,000$
 $A = \$348,000$
Assets = $\$348,000$

- Assets = Liabilities + Owner's Equity
 $3(L) = L + OE$
 $3(\$80,000) = \$80,000 + OE$
 $\$240,000 = \$80,000 + OE$
 $\$240,000 - \$80,000 = OE$
 $\$160,000 = OE$
 $\$160,000$ = Owner's Equity

- (1) $\Delta A = \Delta L + \Delta OE$
 $\uparrow\$80,000 = \downarrow\$30,000 + \Delta OE$
 $\uparrow\$80,000 + \uparrow\$30,000 = \Delta OE$
 $\uparrow\$110,000 = \Delta OE$
Increase of \$110,000 = Change in Owner's Equity

TIP: When the $\downarrow\$30,000$ is moved from the right side of the "=" to the left side of the equation, its sign changes so it becomes a $\uparrow\$30,000$.

TIP: The basic accounting equation is applied at a specific point in time. When you have the facts for the equation components at two different points in time for the same entity (such as amounts as of the beginning of a year and amounts as of the end of the year), you can modify the basic accounting equation to reflect that total changes in assets

equals total changes in liabilities plus total changes in owner's equity. Using the symbol Δ to designate change, the following equation also holds true:

$$\Delta A = \Delta L + \Delta OE$$

- (2) Assets = Liabilities + Owner's Equity
 $\$600,000 = \$340,000 + OE$
 $\$600,000 - \$340,000 = OE$ at January 1, 2000
 $\$260,000 = \text{Owner's Equity at January 1, 2000}$

Owner's Equity at January 1, 2000	\$260,000
Increase in Owner's Equity during 2000 (Answer 1)	<u>110,000</u>
Owner's Equity at December 31, 2000	<u>\$370,000</u>

OR

Assets at January 1, 2000	\$600,000
Increase in Assets during 2000	<u>80,000</u>
Total Assets at December 31, 2000	<u>\$680,000</u>

Liabilities at January 1, 2000	\$340,000
Decrease in Liabilities during 2000	<u>(30,000)</u>
Total Liabilities at December 31, 2000	<u>\$310,000</u>

Assets = Liabilities + Owner's Equity
 $\$680,000 = \$310,000 + OE$
 $\$680,000 - \$310,000 = OE$
 $\$370,000 = OE$
 $\$370,000$ = Owner's Equity at December 31, 2000

6. (1) Assets = Liabilities + Owner's Equity
 $\$500,000 = L + \$280,000$
 $\$500,000 - \$280,000 = L$
 $\$220,000 = L$
 $\$220,000$ = Liabilities at January 1, 2000

- (2) $\Delta A = \Delta L + \Delta OE$
 $\downarrow \$40,000 = \downarrow \$22,000 + \Delta OE$
 $\downarrow \$40,000 + \uparrow \$22,000 = \Delta OE$
 $\downarrow \$18,000 = \Delta OE$
Decrease of \$18,000 = Change in Owner's Equity during 2000

- (3) Owner's Equity at January 1, 2000 \$280,000
Decrease in Owner's Equity during 2000 (Answer 2) (18,000)
Owner's Equity at December 31, 2000 \$262,000

OR

Assets at January 1, 2000	\$500,000
Decrease in Assets during 2000	<u>(40,000)</u>
Assets at December 31, 2000	<u>\$460,000</u>

Liabilities at January 1, 2000 (Answer 1)	\$220,000
Decrease in Liabilities during 2000	<u>(22,000)</u>
Liabilities at December 31, 2000	<u>\$198,000</u>

Assets = Liabilities + Owner's Equity
\$460,000 = \$198,000 + OE
\$460,000 - \$198,000 = OE
\$262,000 = Owner's Equity at December 31, 2000

EXERCISE 1-2

Purpose: (S.O. 7) This exercise illustrates that:

- (1) Each transaction has a dual effect on the basic accounting equation.
- (2) The basic accounting equation remains in balance after each transaction is properly analysed and recorded.

Jean St. Clair owns and operates the Services Marins Laval. A list of the transactions that took place in August 2000 follows:

1. August 1 Jean began the business by depositing \$5,000 of his personal funds in the business bank account.
2. August 2 Jean rented space for the shop behind a strip mall and paid August rent of \$800.
3. August 3 The shop purchased supplies for cash, \$3,000.
4. August 4 The shop paid La Gazette, a local newspaper, \$300 for an ad appearing in the Sunday edition.
5. August 5 Jean repaired a boat for a customer. The customer paid cash of \$1,300 for services rendered.
6. August 11 Services Marins Laval repaired a boat for a customer, Anne Mignard, on credit, \$500.
7. August 13 The shop purchased supplies for \$900 by paying cash of \$200 and charging the rest on account.
8. August 14 The shop repaired a boat for Lise Pommier, a champion skier, for \$1,900. Jean collected \$1,000 in cash and put the rest on account.
9. August 22 Jean took home supplies from the shop that had cost \$100 when purchased on August 3.

10. August 24 The shop collected cash of \$400 from Anne Mignard.
11. August 28 The shop paid \$200 to Nettoyage Laval for cleaning services for the month of August.
12. August 29 Jean repaired a boat for Cyril Turgeon for \$1,200 on account.
13. August 31 Jean transferred \$500 from the business bank account to his personal bank account.

Instructions

Prepare a tabular analysis of the transactions above to indicate the effect of each of the transactions on the various balance sheet items. Use a "+" to indicate an increase and a "-" to indicate a decrease. Indicate the new balances after each transaction. In the owner's equity column, indicate the cause of each change in the owner's total claim on assets. Use the following column headings:

	ASSETS			=	LIABIL- ITIES	+	OWNER'S EQUITY
Transaction	Cash	+ Receivable	+ Supplies		Accounts Payable	+	Jean St. Clair Capital

SOLUTION TO EXERCISE 1-2

Transaction	ASSETS			=	LIABIL-	+	OWNER'S	
	Cash	Receivable	Supplies		ITIES		EQUITY	
	Accounts				Accounts		Jean St. Clair	
					Payable		Capital	
(1)	+\$5,000			=			+\$5,000	Owner Investment
(2)	<u>-800</u>						<u>-800</u>	Rent Expense
Balances	4,200			=			4,200	
(3)	<u>-3,000</u>		<u>+\$3,000</u>					
Balances	1,200		+ 3,000	=			4,200	
(4)	<u>-300</u>						<u>-300</u>	Advertising Expense
Balances	900		+ 3,000	=			3,900	
(5)	<u>+1,300</u>						<u>+1,300</u>	Service Revenue
Balances	2,200		+ 3,000	=			5,200	
(6)		<u>+\$ 500</u>					<u>+500</u>	Service Revenue
Balances	2,200	+ 500	+ 3,000	=			5,700	
(7)	<u>-200</u>		<u>+900</u>		<u>+\$700</u>			
Balances	2,000	+ 500	+ 3,900	=	700		+ 5,700	
(8)	<u>+1,000</u>	<u>+900</u>					<u>+1,900</u>	Service Revenue
Balances	3,000	+ 1,400	+ 3,900	=	700		+ 7,600	
(9)			<u>-100</u>				<u>-100</u>	Drawing
Balances	3,000	+ 1,400	+ 3,800	=	700		+ 7,500	
(10)	<u>+400</u>	<u>-400</u>						
Balances	3,400	+ 1,000	+ 3,800	=	700		+ 7,500	
(11)	<u>-200</u>						<u>-200</u>	Cleaning Expense
Balances	3,200	+ 1,000	+ 3,800	=	700		+ 7,300	
(12)		<u>+1,200</u>					<u>+1,200</u>	Service Revenue
Balances	3,200	2,200	+ 3,800	=	700		+ 8,500	
(13)	<u>-500</u>						<u>-500</u>	Drawing
Balances	<u>\$2,700</u>	+ <u>\$2,200</u>	+ <u>\$3,800</u>	=	<u>\$700</u>		+ <u>\$8,000</u>	

TIP: Make sure the balances at any given point in time reflect equality in the components of the basic accounting equation. If equality does not exist, the work is incomplete or some error has been made. After all transactions are analysed for Services Marins Laval, total assets = \$8,700, total liabilities = \$700, and total owner's equity = \$8,000. The equation is in balance.

TIP: Notice transaction number 7. Even though there were three items affected (Cash, Supplies, and Accounts Payable), the analysis of the transaction maintains balance in the basic accounting equation. Total assets increased by \$700 (\$900 - \$200), and liabilities increased by \$700.

TIP: Notice transaction number 8. Even though there were three items affected (Cash, Accounts Receivable, and J. St. Clair, Capital), the analysis of the transaction maintains balance in the equation. Total assets increased by \$1,900 (\$1,000 + \$900), and owner's equity increased by \$1,900.

Approach: Take each transaction and analyse it separately. Determine if the transaction involves the following:

Assets: Assets are resources owned or controlled by a business. Thus, they are the things of value used in carrying out such activities as production, consumption, and exchange. An asset represents a future economic benefit that will eventually result in an inflow of cash to the holder.

Liabilities: Liabilities are creditor sources of resources or creditorship claims on total assets. They are existing debts and obligations which will become due in the future and will normally require an outlay of cash to be liquidated.

Owner's Equity: The ownership claim on total assets is known as owner's equity. Total assets less total liabilities equals total owner's equity. Accountants often refer to total owner's equity by use of the word **capital**. The components of owner's equity are as follows:

- (1) **Invested capital**—the owner's investment in the business.
- (2) **Earned capital**—business earnings retained for use in the business; net income since the inception of the business less total owner withdrawals (drawings) since the inception of the business.
 - (a) **Net income** is the amount of excess of total revenues over total expenses for a particular period of time. (An excess of total expenses over total revenues for a particular period of time is referred to as **net loss**.)
 - (b) **Revenues** are the gross increases in owner's equity resulting from business activities entered into for the purpose of earning income. Generally, revenues result from the sale of merchandise, the performance of services, the rental of property, or the lending of money.
 - (c) **Expenses** are the costs of assets consumed or services used up in the process of earning revenue. Expenses are the decreases in owner's equity that result from operating the business. Expenses represent actual or expected cash outflows (payments).
 - (d) **Drawings** occur when an owner withdraws cash or other assets for personal use. Owner withdrawals cause a decrease in total owner's equity.

If a transaction involves assets or liabilities, identify which particular asset or liability is affected and in what direction and by what amount. If a transaction involves owner's equity, identify the specific reason for that change—owner investment, owner withdrawal, revenue earned, or expense incurred. Be sure to classify each revenue and expense item by type (for example, salaries expense or rent expense). Also identify the amount and direction of each change in owner's equity. Please refer to Diagram 1-1 which follows.

DIAGRAM 1-1
SUMMARY OF FACTORS INFLUENCING OWNER'S CAPITAL

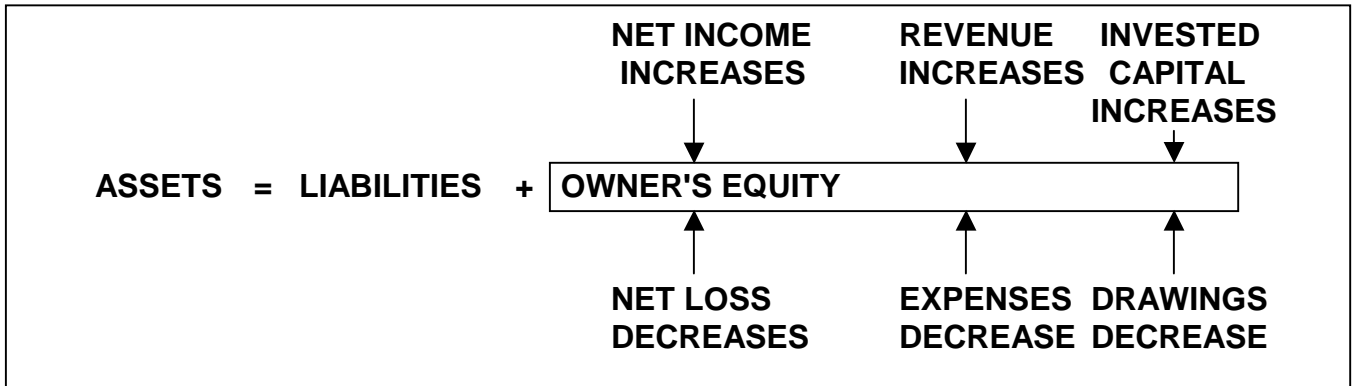


ILLUSTRATION 1-1

DUAL EFFECT OF TRANSACTIONS ON THE BASIC ACCOUNTING EQUATION (S.O. 6, 7)

Each transaction affects items in the basic accounting equation in such a manner as to maintain equality in the basic accounting equation. The possible combinations of dual effects are illustrated below with examples of transactions that fit each category of combinations. Some examples are too advanced to be comprehended at this level in your accounting study so references are made to future chapters for those items. Do not attempt to research those items at this time—just accept the fact that in the future you will more readily understand those examples. These advanced examples are included here to show you that there are illustrations of every conceivable combination of dual effects on the equation.

Effects of Transaction on Basic Equation

Examples

- | | |
|--|---|
| 1. $A = L + OE$
\uparrow \uparrow | a. Owner investment of personal assets into the business.
b. Sale of services for cash or on account. |
| 2. $A = L + OE$
\downarrow \downarrow | a. Owner withdrawal of assets from the business for personal use.
b. Cash payment for various expenses, such as salaries expense and advertising expense. (Also, Chapter 3, consumption of noncash assets in operations, such as the consumption of supplies.) |
| 3. $A = L + OE$
\uparrow \uparrow | a. Acquisition of any asset on credit. Borrowing money. |
| 4. $A = L + OE$
\downarrow \downarrow | a. Paying off any debt. |
| 5. $A = L + OE$
$\downarrow\uparrow$ | a. Exchanging any asset for another asset, such as purchase of equipment for cash or collection of an account receivable. |
| 6. $A = L + OE$
$\uparrow\downarrow$ | a. Exchanging one liability for another, such as settling an account payable by issuing a note payable. |
| 7. $A = L + OE$
$\uparrow\downarrow$ | a. (Chapter 15—Corporation declares a stock dividend). |

ILLUSTRATION 1-1 (Continued)

$$8. \quad A = L + OE$$

\downarrow \uparrow

- a. Liquidating a debt by giving an ownership interest in the entity.
- b. (Chapter 3—Entity earns revenue after cash was previously received and recorded).

$$9. \quad A = L + OE$$

\uparrow \downarrow

- a. (Chapter 15—Corporation declares cash dividends on stock).
- b. (Chapter 3—Incurring expense--consuming benefits in carrying out operations--before paying for the goods or services, such as repairs made to an entity's equipment before the vendor is paid.)

TIP: Examine the examples. Some of them are preceded by an a. and some are preceded by a b. Notice that all of the a. type examples have no impact on the income statement; whereas all of the b. type examples do impact the income statement. All examples above impact the balance sheet.

TIP: A single transaction may affect more than two items in the basic accounting equation and still maintain equality in the equation. For example, if a company received a \$700 bill for repairs to a copier and paid \$500 cash to the vendor along with a promise to pay the remaining \$200 in one month, the transaction would affect the components of the equation as follows:

$$A = L + OE$$

$$\downarrow \$500 = \uparrow \$200 + \downarrow \$700$$

The equation remains in balance.

TIP: As you progress through your accounting course(s) and possibly a career in business, you will constantly encounter new transactions and familiar transactions with a new twist. These unfamiliar situations can be addressed with confidence if you carefully analyse the effects on the basic accounting equation.

EXERCISE 1-3

Purpose: (S.O. 8) This exercise will provide you with an illustration of an income statement, Statement of owner's equity, a balance sheet, and a statement of cash flows.

The Services Marins Laval in Laval, Quebec prepares financial statements each month.

Instructions

Refer to the **Solution to Exercise 1-2** above. Use the information displayed to:

- (a) Prepare an income statement for the month of August 2000.
- (b) Prepare an Statement of owner's equity for the month of August 2000.
- (c) Prepare a balance sheet at August 31, 2000.
- (d) Prepare a statement of cash flows for the month of August 2000.

Approach: Think about what each statement is to report. A summary is as follows:

- (a) The **income statement** reports the results of operations for a period of time. Therefore, the income statement in this exercise reports revenues and expenses for August.
- (b) The **statement of owner's equity** reports all changes in owner's equity for a period of time. It starts with the balance of owner's equity at the beginning of the period. It reports withdrawals (drawings), additional owner investments and includes the net income (or net loss) figure from the income statement to arrive at the balance of owner's equity at the end of the period.
- (c) The **balance sheet** reports on the financial position at a point in time (August 31 in this case). It reports assets, liabilities, and owner's equity. The balance of owner's equity used here comes from the Statement of owner's equity.
- (d) The **statement of cash flows** reports the cash inflows and cash outflows during a period of time and classifies these flows into three activities: (1) operating, (2) investing, and (3) financing.

SOLUTION TO EXERCISE 1-3

- (a) **SERVICES MARINS LAVAL**
Income Statement
For the Month Ended August 31, 2000

Revenues		
Service revenue		\$4,900*
Expenses		
Rent expense	\$800	
Advertising expense	300	
Cleaning expense	<u>200</u>	
Total expenses		<u>1,300</u>
Net income		<u><u>\$3,600</u></u>

*Computation: $\$1,300 + \$500 + \$1,900 + \$1,200 = \$4,900$.

TIP: Even though there were four separate revenue transactions, they are reported in the aggregate on the income statement. Also notice that there is no distinction made on the income statement between cash revenue transactions and revenue transactions that are on account, (Accounts Receivable items). They are simply treated, for now, as Service Revenue!

TIP: As you might be wondering, there are likely some other expenses incurred by the Services Marins Laval during August that have not yet been addressed. For example, some supplies were probably consumed in making repairs. Also, services such as power and telephone likely were consumed in August. These situations will be explained in Chapter 3.

TIP: **Drawings** are often called **owner withdrawals** or simply **withdrawals**. They do **not** appear on the income statement because they are not expenses—they have no impact on operations. Withdrawals are a distribution of company profits and not a determinant of profits (net income). They are reported on the Statement of Owner's Equity, and on the Statement of Cash Flows.

(b) **SERVICES MARINS LAVAL**
Statement of Owner's Equity
For the Month Ended August 31, 2000

Jean St. Clair, Capital, August 1, 2000	\$ 0
Add: Owner investments	5,000
Net income for August 2000	<u>3,600</u>
	8,600
Less: Drawings	<u>600*</u>
Jean St. Clair, Capital, August 31, 2000	<u><u>\$8,000</u></u>

*Computation: \$100 + \$500 = \$600.

(c) **SERVICES MARINS LAVAL**
Balance Sheet
August 31, 2000

Assets	
Cash	\$2,700
Accounts receivable	2,200
Supplies	<u>3,800</u>
Total assets	<u><u>\$8,700</u></u>
Liabilities and Owner's Equity	
Liabilities	
Accounts payable	\$ 700
Owner's Equity	
Jean St. Clair, Capital	<u>8,000</u>
Total liabilities and owner's equity	<u><u>\$8,700</u></u>

TIP: Supplies refers to supplies on hand. Therefore, this item is an asset.

(d)

SERVICES MARINS LAVAL
Statement of Cash Flows
For the Month Ended August 31, 2000

Cash flows from operating activities		
Cash receipts from customers		\$2,700
Cash payments for expenses and supplies		<u>(4,500)</u>
Net cash used by operating activities		(1,800)
Cash flows from investing activities		
[None illustrated here]		
Net cash provided by investing activities		0
Cash flows from financing activities		
Investments by owner	\$5,000	
Drawings by owner	<u>(500)</u>	
Net cash provided by financing activities		<u>4,500</u>
Net increase in cash		2,700
Cash at the beginning of the period		<u>0</u>
Cash at the end of the period		<u>\$2,700</u>

Computations:

Cash receipts from customers: $\$1,300 + \$1,000 + \$400 = \$2,700$.

Cash payments for expenses and supplies: $\$800 + \$3,000 + \$300 + \$200 + \$200 = \$4,500$.

TIP: Notice that although the owner's capital balance is \$8,000, the balance of cash is far less than that. Also notice what gave rise to that \$8,000 balance of owner's equity: the owner invested \$5,000, the company has operated at a profit of \$3,600 (total revenues exceeded total expenses) since its inception, and total company earnings (\$3,600) exceed total owner withdrawals (\$600). Therefore, the ending owner's equity stems from owner investments of \$5,000 and undistributed earnings of \$3,000.

TIP: Think about the logical order in which the financial statements are prepared: 1. Income statement, 2. Statement of Owner's Equity, and 3. Balance sheet. That's because the income statement provides the net income figure used to compute the change in owner's equity. All changes in owner's equity are reported on the statement of owner's equity to determine the ending balance for owner's equity. That ending owner's equity balance is then used as a necessary component of the balance sheet.

TIP: Notice that everything on the balance sheet in the liabilities and owner's equity section lacks physical existence. The balance of Accounts Payable represents the total amount owed at the balance sheet date to suppliers of goods and services because of past transactions. The balance of Jean St. Clair, Capital tells us the dollar amount of the entity's resources at the balance sheet date which have resulted from the owner's investments and the entity's profitable operations (i.e., profits that have not been distributed to the owner). Notice that in this particular situation the ending balance of owner's equity exceeds the amount of cash. Also, the amount of net income for the month of August exceeds the amount of cash at August 31, 2000.

EXERCISE 1-4

Purpose: (S.O. 8) This exercise will give you practice in classifying items on financial statements.

- | | |
|-------------------------------|-------------------------------------|
| _____ 1. Cash | _____ 15. Fees incurred |
| _____ 2. Accounts payable | _____ 16. Telephone expense |
| _____ 3. Equipment | _____ 17. Cleaning supplies on hand |
| _____ 4. Utilities expense | _____ 18. Property taxes payable |
| _____ 5. A. Hammer, capital | _____ 19. Cleaning expense |
| _____ 6. Salaries payable | _____ 20. Commission expense |
| _____ 7. Salaries expense | _____ 21. Commission revenue |
| _____ 8. Advertising expense | _____ 22. Insurance expense |
| _____ 9. Advertising payable | _____ 23. Rent expense |
| _____ 10. Office supplies | _____ 24. Rent revenue |
| _____ 11. Note payable | _____ 25. Interest expense |
| _____ 12. Note receivable | _____ 26. Interest revenue |
| _____ 13. A. Hammer, drawings | _____ 27. Interest income |
| _____ 14. Fees earned | _____ 28. Office supplies expense |
| _____ 29. Owner withdrawals | _____ 35. Mortgage payable |

_____ 30.	Service revenue	_____ 36.	Loan receivable
_____ 31.	Legal fees earned	_____ 37.	Bank loan payable
_____ 32.	Legal fees incurred	_____ 38.	Royalty revenue
_____ 33.	Prepaid insurance	_____ 39.	Royalty expense
_____ 34.	Property tax expense	_____ 40.	Medical supplies

Instructions

Indicate how each of the above should be classified on a set of financial statements. Use the following abbreviations to communicate your responses.

A	Asset on the balance sheet
L	Liability on the balance sheet
OE	Owner's equity balance on the balance sheet
D	Drawings on the statement of owner's equity
R	Revenue on the income statement
E	Expense on the income statement

SOLUTION TO EXERCISE 1-4

Approach: Look for the key word or words, if any, in each individual item. For examples, a list of key words or phrases follows along with the likely classifications:

Key word (phrases)	Classification
Revenue	Revenue on the income statement
Expense	Expense on the income statement
Earned	Revenue on the income statement
Incurred	Expense on the income statement
On hand	Asset on the balance sheet
Prepaid	Asset on the balance sheet
Receivable	Asset on the balance sheet
Payable	Liability on the balance sheet

1. A	11. L	21. R	31. R
2. L	12. A	22. E	32. E
3. A	13. D	23. E	33. A
4. E	14. R	24. R	34. E
5. OE	15. E	25. E	35. L
6. L	16. E	26. R	36. A
7. E	17. A	27. R ^a	37. L
8. E	18. L	28. E	38. R
9. L	19. E	29. D	39. E
10. A	20. E	30. R	40. A

^aThe word income in an item is often used instead of the word revenue. Such as rent income, interest income, and commission income.

TIP: Keep in mind that an asset is an item that offers probable future economic benefits. If something will assist the revenue generating process of a future accounting period, it is an asset.

TIP: You can determine the position of an entity in a particular transaction by the wording of the explanation. For example, we would use the item "bank loan payable" (a liability) if we had borrowed money from the bank. The bank would have "loan receivable" (an asset) item on their balance sheet. As another example, we would have "legal fees incurred" (an expense) on our income statement if we had used legal services. The law firm which provided the services would report a corresponding "legal fees earned" (revenue) item on its income statement.

EXERCISE 1-5

Purpose: (S.O. 6, 7, 8) This exercise reviews the basic accounting equation ($A = L + OE$) and the connection between the income statement and the balance sheet. The connection is a change in owner's equity due to the net income or net loss for the period.

The following data were extracted from the records of Nge Aung Sport Ltd., a sole proprietorship:

Total assets, beginning of the period	\$250,000
Total liabilities, beginning of the period	90,000
Owner drawings during the period	75,000
Total assets, end of the period	270,000
Total liabilities, end of the period	95,000
Owner's contributions during the period	25,000

Instructions

Compute the amount of net income (or net loss) for the period. Show your computations.

SOLUTION TO EXERCISE 1-5

Approach: The question asks you to solve for net income; however, no information is given regarding revenues and expenses for the period. Only balance sheet data and transactions affecting owner's equity are given. Net income (or net loss) for a period is one reason for change in the balance of owner's equity. Write down the items that reconcile the beginning owner's equity balance with the ending owner's equity balance, enter the amounts known, compute beginning and ending owner's equity balances by use of the basic accounting equation, and then solve for the amount of net income.

Beginning owner's equity	\$160,000 ^a
Additional owner contributions	25,000
Owner withdrawals during the period	<u>(75,000)</u>
Subtotal	110,000
Net income (loss) for the period	<u>+ X</u>
Ending owner's equity	<u>\$175,000^b</u>
 Solving for X, net income =	 <u>\$65,000</u>

$${}^aA = L + OE$$

$$\$250,000 = \$90,000 + ?$$

$$\text{Beginning owner's equity} = \$160,000$$

$${}^bA = L + OE$$

$$\$270,000 = \$95,000 + ?$$

$$\text{Ending owner's equity} = \$175,000$$

TIP: Solving an exercise of this type requires a lot of thought and a clear understanding of the relationships of accounting data.

EXERCISE 1-6

Purpose: (S.O. 1 thru 8) This exercise will quiz you about terminology used in this chapter.

A list of accounting terms with which you should be familiar appears below.

Accounting	Liabilities
Accounting Standards Board	Management consulting
Assets	Monetary unit assumption
Auditing	Net income
Balance sheet	Net loss
Basic accounting equation	Owner's equity
Bookkeeping	Partnership
Corporation	Private (or managerial) accounting
Cost principle	Proprietorship
Drawings	Provincial Securities Commissions, e.g. Ontario Securities Commission
Economic entity assumption	Public accounting
Ethics	Revenues
Expenses	Statement of cash flows
Generally accepted accounting principles (GAAP)	Statement of owner's equity
Income statement	Taxation
Investments by owner	Transactions

Instructions

For each item below, enter in the blank the term that is described.

- _____ The process of identifying, recording, and communicating the economic events of an organization to interested users of the information.
- _____ An accounting principle that states that assets should be recorded at their cost.
- _____ A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time. Sometimes called the **operating statement**.
- _____ The gross increase in owner's equity resulting from business activities entered into for the purpose of earning income; also, economic assets which result from providing goods and services to customers.
- _____ The cost of assets consumed or services used in the process of earning revenue.
- _____ $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$.

-
7. _____ Resources owned by a business.
 8. _____ Creditorship claims on total assets.
 9. _____ The ownership claim on total assets.
 10. _____ A financial statement that reports the assets, liabilities, and owner's equity at a specific date. Sometimes called the **statement of financial position**.
 11. _____ A common set of standards that indicate how to report economic events.
 12. _____ A financial statement that summarizes the changes in owner's equity for a specific period of time.
 13. _____ An assumption stating that only transaction data that can be expressed in terms of money be included in the accounting records of the economic entity; accountants treat the unit of measure as relatively constant over time.
 14. _____ An assumption that economic events can be identified with a particular unit of accountability; also, that the business' financial records will be kept separate from those of its owner(s), and those of other business entities.
 15. _____ The economic events of the enterprise recorded by accountants; first in a Journal, and then in a Ledger.
 16. _____ Withdrawal of cash or other assets from an unincorporated business for the personal use of the owner(s).
 17. _____ A financial statement that provides information about the cash inflows (receipts) and cash outflows (payments) of an entity for a specific period of time.
 18. _____ The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation.
 19. _____ An area of public accounting involving tax advice, tax planning, and preparing tax returns.
 20. _____ An area of public accounting involving financial planning and control and the development of accounting and computer systems.

21. _____ An area of accounting in which the accountant offers expert service to the general public.
22. _____ An area of accounting within a company that involves such activities as cost accounting, budgeting, and accounting information systems.
23. _____ A private organization that establishes generally accepted accounting principles.
24. _____ A governmental agency that requires companies to file financial reports in accordance with generally accepted accounting principles.
25. _____ The amount by which revenues exceed expenses for a specific period of time.
26. _____ A business organized as a separate legal entity under provincial or federal corporation law having ownership divided into transferable shares of stock.
27. _____ An association of two or more persons to carry on as co-owners of a business for profit.
28. _____ A business owned by one person.
29. _____ The amount of resources (assets) put into the business by the owner.
30. _____ A part of accounting that involves only the recording of economic events.
31. _____ The amount by which expenses exceed revenues for a specific period of time.
32. _____ The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair.

SOLUTION TO EXERCISE 1-6

1. Accounting
2. Cost principle
3. Income statement
4. Revenues
5. Expenses
6. Basic accounting equation
7. Assets
8. Liabilities
9. Owner's equity
10. Balance sheet
11. Generally accepted accounting principles
12. Statement of owner's equity
13. Monetary unit assumption
14. Economic entity assumption
15. Transactions
16. Drawings
17. Statement of cash flows
18. Auditing
19. Taxation
20. Management consulting
21. Public accounting
22. Private (or managerial) accounting
23. Accounting Standards Board
24. Provincial Securities Commission
25. Net income
26. Corporation
27. Partnership
28. Proprietorship
29. Investments by owner
30. Bookkeeping
31. Net loss
32. Ethics

ANALYSIS OF MULTIPLE-CHOICE TYPE QUESTIONS**1. Question**

(S.O. 2) Which of the following terms refers to the process of reviewing the accounting records and reports to evaluate the fairness of the presentations in the reports and their compliance with established guidelines and rules?

- a. Auditing.
- b. Tax return preparation.
- c. Management consulting work.
- d. Public accounting.

Approach and Explanation: Briefly define each answer selection. Compare your definitions with the question stem to determine your answer. Auditing services are provided by public accounting firms. An audit is an examination of the financial statements of a company for the purpose of an expression of an opinion as to the fairness of presentation. Tax return preparation involves preparing tax returns, usually without any verification of the data to be used for completion. Management consulting work involves giving advice to management on various matters. Public accounting involves providing services to clients. As a public accountant, an individual may perform one or more of the following services: auditing, taxation, and management consulting. (Solution = a.)

2. Question

(S.O. 5) Which accounting assumption or principle dictates that a business owner's personal expenses should not be recorded on the books of the business?

- a. Economic entity assumption.
- b. Monetary unit assumption.
- c. Cost principle.
- d. Basic accounting equation.

Approach and Explanation: Briefly explain each answer selection. Compare your explanations with the question. The economic entity assumption requires that the activities of the entity be kept separate and distinct from (1) the activities of its owner, and (2) all other economic entities. The monetary unit assumption requires that only transaction data that can be expressed in terms of money be included in the accounting records and provides that all transactions and events can be measured in terms of a common denominator—units of money. The cost principle states that assets should be recorded at cost and indicates that cost is measured by the value exchanged at the time something is acquired. The basic accounting equation provides that total assets at a point in time equals total liabilities plus total owner's equity at the same point in time. (Solution = a.)

3. Question

(S.O. 4) The Seller Company sold the Buyer Company a building on August 1, 2000. Buyer Company paid Seller Company \$92,000 cash. The Seller Company had originally purchased the building in 1993 for \$80,000. The county taxing authority showed an assessed valuation of \$78,000 for the building for 1999 taxing purposes and an independent appraisal agency appraised it at \$95,000 on July 15, 2000. The Buyer Company should record the building in their accounting books at:

- a. \$78,000.
- b. \$80,000.
- c. \$92,000.
- d. \$95,000.

Approach and Explanation: Read the last sentence first. You can tell by that last sentence the Buyer is acquiring a building (an asset). Think about the cost principle. It provides that all assets be recorded at cost. Cost is measured by the value exchanged at the time something is acquired. In this case, the cash payment of \$92,000 clearly determines the cost of the building to the Buyer Company. (Solution = c.)

4. Question

(S.O. 8) The balance sheet is sometimes called the:

- Earnings statement.
- Operating statement.
- Profit and loss statement.
- Statement of financial position.

Approach and Explanation: Read the question stem. Think of alternative names for the balance sheet. Then take each answer selection and see if it agrees with your response or not. Answer selections a., b., and c. are all alternative names for the income statement. Statement of financial position is a name for the balance sheet because it reports on the entity's financial position at a point in time. Statement of assets and equities might be another (but not popular) alternative name for the balance sheet. (Solution = d.)

5. Question

(S.O. 6, 7) At January 1, 2000, Tellier Company's assets totaled \$70,000, and its liabilities amounted to \$40,000. Net income for 2000 was \$24,000 and owner withdrawals amounted to \$25,000. At December 31, 2000, assets totaled \$90,000, and liabilities amounted to \$57,000. The amount of additional owner investments during 2000 amounted to:

- \$0.
- \$2,000.
- \$3,000.
- \$4,000.
- Cannot be determined from the facts given.

Approach: Use your knowledge of the basic accounting equation and reasons for changes in owner's equity to solve.

Explanation:

	A	=	L	+	OE	
	\$70,000		\$40,000		\$30,000 ^a	Balance at 1/1/00
					24,000	Net income for 2000
					(25,000)	Drawings for 2000
					+ X	Investments for 2000
	\$90,000		\$57,000		+ \$33,000 ^b	Balance at 12/31/00

$$^a\$70,000 - \$40,000 = \$30,000$$

$$^b\$90,000 - \$57,000 = \$33,000$$

$$\text{Solving for X: } \$30,000 + \$24,000 - \$25,000 + X = \$33,000$$

$$\$29,000 + X = \$33,000$$

$$X = \$33,000 - \$29,000$$

$$X = \underline{\$4,000} \text{ owner investments during 2000}$$

(Solution = d.)

6. Question

(S.O. 6, 7) At January 1, 2000, King Corporation's assets totaled \$76,000, and its liabilities amounted to \$42,000. Net income for 2000 was \$17,000, and owner drawings amounted to \$13,000. The amount of owner's equity at December 31, 2000 is:

- \$38,000.
- \$51,000.
- \$80,000.
- \$93,000.

Approach: Use your knowledge of the basic accounting equation and reasons for changes in owner's equity to solve.

Explanation:

A	=	L	+	OE	
\$76,000	=	\$42,000	+	OE at 1/1/00	
\$76,000 - \$42,000	=	\$34,000		OE at 1/1/00	
\$34,000				Owner's equity at January 1, 2000	
17,000				Net income for 2000	
(13,000)				Drawings for 2000	
<u>0</u>				Additional owner investments for 2000	
<u>\$38,000</u>				Owner's equity at December 31, 2000	(Solution = a.)

7. Question

(S.O. 7) Which of the following phrases describes the effects of the purchase of an asset on account?

- Increase in assets and increase in expenses.
- Increase in assets and increase in liabilities.
- Increase in expenses and increase in liabilities.
- Increase in liabilities and decrease in owner's equity.

Approach: Determine the effects of the transaction and write them down before you read the answer selections. Write down the basic accounting equation and analyse the effects of the transaction on the elements of the equation. If the transaction affects owner's equity, clearly state why and how.

Explanation:

A	=	L	+	OE	
↑		↑			(Solution = b.)

8. Question

(S.O. 6) Which of the following statements is **not** true about all expenses?

- They result in a decrease in owner's equity.
- They result from the consumption of goods and services.
- They occur in the process of generating revenue.
- They are the same thing as liabilities.

Approach and Explanation: Write down the definition of expense and the possible effects of an expense type transaction on the basic accounting equation. Then take each answer selection and see if it is true or not true about all expenses. An expense is the cost of an asset or other goods or services consumed in the process of generating revenue. The possible effects of an expense on the basic accounting equation are as follows:

$$\begin{array}{ccc}
 & A = L + OE & \\
 & \downarrow & \downarrow \\
 \text{OR} & & \uparrow \quad \downarrow
 \end{array}$$

Liabilities are debts or obligations. A liability may arise because an asset is acquired on credit or because money is borrowed. A liability may arise in an expense transaction but not all expense transactions involve liabilities. Liabilities and expenses are **not** synonymous terms. (Solution = d.)

9. Question

(S.O. 7) Which of the following statements is true regarding the current period's consumption of office supplies which were purchased and recorded as an asset in a prior accounting period?

- Total assets remain unchanged.
- Total owner's equity decreases.
- Total liabilities increase.
- Total assets increase.

Approach and Explanation: Write down the effects of the consumption of office supplies previously on hand. The supplies were an asset when they were on hand. Now, they are an expense because they have been consumed. Therefore, assets decrease, and owner's equity decreases. (Solution = b.)

10. Question

(S.O. 7) Which of the following statements is true regarding the effect of the purchase of equipment for cash?

- Total assets decrease.
- Total liabilities increase.
- Total assets remain unchanged.
- Total owner's equity decreases.

Approach and Explanation: Think about the transaction. Cash (an asset) decreases. Equipment (another asset) increases by the same amount. There is no effect on liabilities or owner's equity. Look for the answer selection that fits the effects described. (Solution = c.)

$$A = L + OE$$

↓↑

11. Question

(S.O. 6) Which of the following items is an example of a liability?

- Wages expense.
- Mortgage payable.
- Accounts receivable.
- Owner's equity

Approach and Explanation: Think about the definition of a liability. Key words often associated with a liability are "debt," "obligation," or "payable." Examine each answer selection and determine its classification on financial statements. Write down your responses. Wages expense is an expense item on the income statement. Mortgage payable is a liability (Bingo!). Accounts receivable is an asset (key word is receivable). Owner's equity is owner's equity on the balance sheet. (Solution = b.)

12. Question

(S.O. 7) The effects of a withdrawal by an owner are to

- Increase expenses and decrease net income.
- Increase expenses and decrease owner's equity.
- Decrease assets and decrease net income.
- Decrease assets and decrease owner's equity.

Approach and Explanation: Write down the basic accounting equation and use arrows to indicate the effects of an owner withdrawal (of cash or other assets).

$$A = L + OE$$

↓ ↓

Examine each answer selection and see if it fits your description. An owner withdrawal is not an expense because it does not have anything to do with carrying out operations and generating revenue; it is a distribution of profits to the owner. (Solution = d.)