1 Accounting in Business

A Look at This Chapter
Accounting plays a crucial role in the information age. In this chapter, we discuss the importance of accounting to different types of organizations and describe its many users and uses. We explain that ethics are crucial to accounting. We also describe business transactions and how they are reflected in financial statements.

A Look Ahead
Chapter 2 further describes and analyzes business transactions. We explain the analysis and recording of transactions, the ledger and trial balance, and the double-entry system. Chapters 2 and 3 together show (via the accounting cycle) how financial statements reflect business activities.

Learning Objectives

Conceptual
C1 Explain the purpose and importance of accounting in the information age. (p. 4)
C2 Identify users and uses of accounting. (p. 5)
C3 Identify opportunities in accounting and related fields. (p. 6)
C4 Explain why ethics are crucial to accounting. (p. 8)
C5 Explain the meaning of generally accepted accounting principles and define and apply several key accounting principles. (p. 9)
C6 Appendix 1B—Identify and describe the three major activities in organizations. (p. 24)

Analytical
A1 Define and interpret the accounting equation and each of its components. (p. 12)
A2 Analyze business transactions using the accounting equation. (p. 13)
A3 Compute and interpret return on assets. (p. 20)
A4 Appendix 1A—Explain the relation between return and risk. (p. 23)

Procedural
P1 Identify and prepare basic financial statements and explain how they interrelate. (p. 17)
“Ask everyone to give you money… remember, you hold the opportunity for them”
—Shawn Nelson

Decision Feature

I Should Have Thought of That!

SALT LAKE CITY—Trying to get comfortable while watching TV, Shawn Nelson thought “a huge beanbag thing” would be far more relaxing than his old couch. So he made one—a big one! Seven feet across and shaped like a baseball, Shawn’s creation was the talk of friends and neighbors. Shortly after making and selling a few “huge beanbag things,” Shawn knew it needed a better name. Drawing on the 1960s retro spirit of “love and peace,” Shawn named his invention the LoveSac and his company (LoveSac.com) was born.

Yet LoveSac’s launch was anything but smooth. Shawn began by working out of his mother’s basement. He then set up shop at trade shows and even the local drive-in cinema. He got his first big break when Limited Too called after seeing his display at a trade show. “I answered the phone,” says Shawn, “Twelve thousand Sacs? Sure, no problem.” Who was he kidding?

Shawn’s credit card debt swelled to over $50,000 as he worked 19-hour days and slept in the aged building in which he manufactured the Sacs. “It nearly broke me emotionally, physically, mentally,” Shawn recalls. “We finished the order but ate up all our profits.” Without profits his business, too, would soon be retro. So Shawn approached furniture retailers to ask if they would carry Sacs. “Shawn can still hear the laughter,” states LoveSac’s Website.

Just when things seemed bleakest, Shawn’s cousin suggested he open a retail location. Desperate, Shawn took a three-month lease in a shopping mall. His goal: sell one SuperSac per day. This would cover rent and pay him and his cousin a $5 hourly wage. Shawn then developed a transaction-based accounting system to get a handle on orders and sales. He also selected an organizational form and constructed financial measures and reports.

Incredibly, customers crowded into his store within days of opening. Four weeks later and just before Christmas, customers were lined up outside the door waiting for Sacs to arrive from the factory. By Christmas Eve, Shawn’s store was nearly sold out. Today, Shawn has more than 60 stores projected to generate over $30 million in sales. With results like that we’d all croon over Sacs! [Sources: LoveSac Website, January 2006; Entrepreneur, November 2004; LA Confidential, Fall 2004; Life & Style Weekly, June 2005.]
Chapter Preview

Today’s world is one of information—its preparation, communication, analysis, and use. Accounting is at the heart of this information age. Knowledge of accounting gives us career opportunities and the insight to take advantage of them. This book introduces concepts, procedures, and analyses that help us make better decisions. In this chapter we describe accounting, the users and uses of accounting information, the forms and activities of organizations, and several accounting principles. We also introduce transaction analysis and financial statements.

Importance of Accounting

We live in an information age—a time of communication and immediate access to data, news, facts, and commentary. Information affects how we live, whom we associate with, and the opportunities we have. To fully benefit from the available information, we need knowledge of the information system. An information system consists of the collecting, processing, and reporting of information to decision makers.

Providing information about what businesses own, what they owe, and how they perform is an important aim of accounting. Accounting is an information and measurement system that identifies, records, and communicates relevant, reliable, and comparable information about an organization’s business activities. Identifying business activities requires selecting transactions and events measured in dollars and classified and summarized in a useful format. Recording business activities requires preparing accounting reports such as financial statements. It also requires analyzing and interpreting such reports. (The financial statements and notes of Best Buy are shown in Appendix A of this book. This appendix also shows the financial statements of Circuit City and Apple Computer.) Exhibit 1.1 summarizes accounting activities.

We must guard against a narrow view of accounting. The most common contact with accounting is through credit approvals, checking accounts, tax forms, and payroll. These

Exhibit 1.1

Accounting Activities

Select transactions and events

Input, measure, and classify

Prepare, analyze, and interpret
experiences are limited and tend to focus on the recordkeeping parts of accounting. **Recordkeeping**, or **bookkeeping**, is the recording of transactions and events, either manually or electronically. This is just one part of accounting. Accounting also identifies and communicates information on transactions and events, and it includes the crucial processes of analysis and interpretation.

Technology is a key part of modern business and plays a major role in accounting. Technology reduces the time, effort, and cost of recordkeeping while improving clerical accuracy. Some small organizations continue to perform various accounting tasks manually, but even they are impacted by information technology. As technology has changed the way we store, process, and summarize masses of data, accounting has been freed to expand. Consulting, planning, and other financial services are now closely linked to accounting. These services require sorting through data, interpreting their meaning, identifying key factors, and analyzing their implications.

**Users of Accounting Information**

Accounting is often called the **language of business** because all organizations set up an accounting information system to communicate data to help people make better decisions. Exhibit 1.2 shows that the accounting information system serves many kinds of users who can be divided into two groups: external users and internal users.

**External Information Users**

External users of accounting information are not directly involved in running the organization. They include shareholders (investors), lenders, directors, customers, suppliers, regulators, lawyers, brokers, and the press. External users have limited access to an organization’s information. Yet their business decisions depend on information that is reliable, relevant, and comparable.

**Financial accounting** is the area of accounting aimed at serving external users by providing them with financial statements. These statements are known as **general-purpose financial statements**. The term general-purpose refers to the broad range of purposes for which external users rely on these statements.

Each external user has special information needs depending on the types of decisions to be made. **Lenders** (creditors) loan money or other resources to an organization. Banks, savings and loans, co-ops, and mortgage and finance companies often are lenders. Lenders look for information to help them assess whether an organization is likely to repay its loans with interest. **Shareholders** (investors) are the owners of a corporation. They use accounting reports in deciding whether to buy, hold, or sell stock. Shareholders typically elect a **board of directors** to oversee their interests in an organization. Since directors are responsible to shareholders, their information needs are similar. **Employees** and **labor unions** use financial statements to judge the fairness of wages, assess job

**C2** Identify users and uses of accounting.
prospects, and bargain for better wages. Regulators often have legal authority over certain activities of organizations. For example, the Internal Revenue Service (IRS) and other tax authorities require organizations to file accounting reports in computing taxes. Other regulators include utility boards that use accounting information to set utility rates and securities regulators that require reports for companies that sell their stock to the public.

Accounting serves the needs of many other external users. Voters, legislators, and government officials use accounting information to monitor and evaluate government receipts and expenses. Contributors to nonprofit organizations use accounting information to evaluate the use and impact of their donations. Suppliers use accounting information to judge the soundness of a customer before making sales on credit, and customers use financial reports to assess the staying power of potential suppliers.

Internal Information Users Internal users of accounting information are those directly involved in managing and operating an organization. They use the information to help improve the efficiency and effectiveness of an organization. Managerial accounting is the area of accounting that serves the decision-making needs of internal users. Internal reports are not subject to the same rules as external reports and instead are designed with the special needs of internal users in mind.

There are several types of internal users, and many are managers of key operating activities. Research and development managers need information about projected costs and revenues of any proposed changes in products and services. Purchasing managers need to know what, when, and how much to purchase. Human resource managers need information about employees’ payroll, benefits, performance, and compensation. Production managers depend on information to monitor costs and quality. Distribution managers need reports for timely, accurate, and efficient delivery of products and services. Marketing managers use reports about sales and costs to target consumers, set prices, and monitor consumer needs, tastes, and price concerns. Service managers require information on the costs and benefits of looking after products and services. Decisions of these and other internal users depend on accounting reports.

Both internal and external users rely on internal controls to monitor and control company activities. Internal controls are procedures designed to protect company property and equipment, ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies. Examples are good records, physical controls (locks, passwords, guards), and independent reviews.

Opportunities in Accounting Accounting information affects many aspects of our lives. When we earn money, pay taxes, invest savings, budget earnings, and plan for the future, we are influenced by accounting. Accounting has four broad areas of opportunities: financial, managerial, taxation, and accounting-related. Exhibit 1.3 lists selected opportunities in each area.

The majority of accounting opportunities are in private accounting, as shown in Exhibit 1.4. Public accounting offers the next largest number of opportunities. Still other opportunities exist in government (and not-for-profit) agencies, including business regulation and investigation of law violations.

Accounting specialists are highly regarded. Their professional standing often is denoted by a certificate. Certified public accountants (CPAs) must meet education and experience requirements, pass an examination, and exhibit ethical character. Many accounting specialists hold certificates in addition to or instead of the CPA. Two of the most common are the certificate
Individuals with accounting knowledge are always in demand as they can help with financial analysis, strategic planning, e-commerce, product feasibility analysis, information technology, and financial management. Benefit packages can include flexible work schedules, telecommuting options, career path alternatives, casual work environments, extended vacation time, and child and elder care.

Demand for accounting specialists is boosting salaries. Exhibit 1.5 reports average annual salaries for several accounting positions. Salary variation depends on location, company size, professional designation, experience, and other factors. For example, salaries for chief financial officers (CFO) range from under $75,000 to more than $1 million per year. Likewise, salaries for bookkeepers range from under $30,000 to more than $80,000.

### Exhibit 1.3
Accounting Opportunities

- Financial
  - Preparation
  - Analysis
  - Auditing
  - Regulatory
  - Consulting
  - Criminal investigation
- Managerial
  - General accounting
  - Cost accounting
  - Budgeting
  - Internal auditing
  - Consulting
  - Controller
  - Treasurer
  - Strategy
- Taxation
  - Preparation
  - Planning
  - Regulatory
  - Investigations
  - Consulting
  - Enforcement
  - Legal services
  - Estate plans
- Accounting-related
  - Lenders
  - Consultants
  - Analysts
  - Traders
  - Directors
  - Underwriters
  - Planners
  - Appraisers
  - FBI investigators
  - Market researchers
  - Systems designers
  - Merger services
  - Business valuation
  - Human services
  - Litigation support
  - Entrepreneurs

### Exhibit 1.4
Accounting Jobs by Area

- Private accounting 60%
- Public accounting 25%
- Government, not-for-profit and education 15%

### Exhibit 1.5
Accounting Salaries for Selected Fields

<table>
<thead>
<tr>
<th>Field</th>
<th>Title (experience)</th>
<th>2006 Salary</th>
<th>2011 Estimate*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Accounting</td>
<td>Partner</td>
<td>$181,000</td>
<td>$231,000</td>
</tr>
<tr>
<td></td>
<td>Manager (6–8 years)</td>
<td>89,500</td>
<td>114,000</td>
</tr>
<tr>
<td></td>
<td>Senior (3–5 years)</td>
<td>68,500</td>
<td>87,500</td>
</tr>
<tr>
<td></td>
<td>Junior (0–2 years)</td>
<td>49,000</td>
<td>62,500</td>
</tr>
<tr>
<td>Private Accounting</td>
<td>CFO</td>
<td>221,000</td>
<td>282,000</td>
</tr>
<tr>
<td></td>
<td>Controller/Treasurer</td>
<td>140,000</td>
<td>179,000</td>
</tr>
<tr>
<td></td>
<td>Manager (6–8 years)</td>
<td>83,000</td>
<td>106,000</td>
</tr>
<tr>
<td></td>
<td>Senior (3–5 years)</td>
<td>69,000</td>
<td>88,000</td>
</tr>
<tr>
<td></td>
<td>Junior (0–2 years)</td>
<td>47,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Recordkeeping</td>
<td>Full-charge bookkeeper</td>
<td>55,000</td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>Accounts manager</td>
<td>48,500</td>
<td>62,000</td>
</tr>
<tr>
<td></td>
<td>Payroll manager</td>
<td>52,000</td>
<td>66,000</td>
</tr>
<tr>
<td></td>
<td>Accounting clerk (0–2 years)</td>
<td>35,500</td>
<td>45,000</td>
</tr>
</tbody>
</table>

* Estimates assume a 5% compounded annual increase over current levels.

### Point:
The Census Bureau reports that for workers 18 and over, higher education yields higher average pay:
- Advanced degree: $74,602
- Bachelor’s degree: $51,206
- High school degree: $27,915
- No high school degree: $18,734

For updated salary information: [www.AICPA.org](http://www.AICPA.org) [Abbott-Langer.com](http://Abbott-Langer.com) [Kforce.com](http://Kforce.com)
Accounting is guided by principles, standards, concepts, and assumptions. This section describes several of these key fundamentals of accounting.

**Ethics—A Key Concept**

The goal of accounting is to provide useful information for decisions. For information to be useful, it must be trusted. This demands ethics in accounting. Ethics are beliefs that distinguish right from wrong. They are accepted standards of good and bad behavior.

Identifying the ethical path is sometimes difficult. The preferred path is a course of action that avoids casting doubt on one’s decisions. For example, accounting users are less likely to trust an auditor’s report if the auditor’s pay depends on the success of the client being audited. To avoid such concerns, ethics rules are often set. For example, auditors are banned from direct investment in their client and cannot accept pay that depends on figures in the client’s reports.

Exhibit 1.6 gives guidelines for making ethical decisions.

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**Quick Check**

1. What is the purpose of accounting?
2. What is the relation between accounting and recordkeeping?
3. Identify some advantages of technology for accounting.
4. Who are the internal and external users of accounting information?
5. Identify at least five types of managers who are internal users of accounting information.
6. What are internal controls and why are they important?
The specific principles are described as we encounter them in the book. General principles are portrayed as building blocks of GAAP in Exhibit 1.7.

Accounting principles are of two types. General principles are the basic assumptions, concepts, and guidelines for preparing financial statements. Specific principles are detailed rules used in reporting business transactions and events. General principles stem from long-used accounting practices. Specific principles arise more often from the rulings of authoritative groups.

We need to understand both general and specific principles to effectively use accounting information. Several general principles are described in this section and several others are described in later chapters. General principles are portrayed as building blocks of GAAP in Exhibit 1.7. The specific principles are described as we encounter them in the book.

The objectivity principle means that accounting information is supported by independent, unbiased evidence. It demands more than a person’s opinion. Information is not reliable if it is based only on what a preparer thinks might be true. A preparer can be too optimistic or pessimistic. The objectivity principle is intended to make financial statements useful by ensuring they report reliable and verifiable information.

The cost principle means that accounting information is based on actual cost. Cost is measured on a cash or equal-to-cash basis. This means if cash is given for a service, its cost is measured as the amount of cash paid. If something besides cash is exchanged (such as a car traded for a truck), cost is measured as the cash value of what is given up or received. The cost principle emphasizes reliability, and information based on cost is considered objective. To illustrate, suppose a company pays $5,000 for equipment. The cost principle requires

C5 Explain the meaning of generally accepted accounting principles and define and apply several key accounting principles.

Point: State ethics codes require CPAs who audit financial statements to disclose areas where their statements fail to comply with GAAP. If CPAs fail to report noncompliance, they can lose their licenses and be subject to criminal and civil actions and fines.

Point: The cost principle is also called the historical cost principle.

Exhibit 1.7

Building Blocks for GAAP
that this purchase be recorded at a cost of $5,000. It makes no difference if the owner thinks this equipment is worth $7,000.

The going-concern principle means that accounting information reflects an assumption that the business will continue operating instead of being closed or sold. This implies, for example, that property is reported at cost instead of, say, liquidation values that assume closure.

The monetary unit principle means that we can express transactions and events in monetary, or money, units. Money is the common denominator in business. Examples of monetary units are the dollar in the United States, Canada, Australia, and Singapore; the pound sterling in the United Kingdom; and the peso in Mexico, the Philippines, and Chile. The monetary unit a company uses in its accounting reports usually depends on the country where it operates, but many companies today are expressing reports in more than one monetary unit.

Revenue (sales) is the amount received from selling products and services. The revenue recognition principle provides guidance on when a company must recognize revenue. To recognize means to record it. If revenue is recognized too early, a company would look more profitable than it is. If revenue is recognized too late, a company would look less profitable than it is. The following three concepts are important to revenue recognition. (1) Revenue is recognized when earned. The earnings process is normally complete when services are performed or a seller transfers ownership of products to the buyer. (2) Proceeds from selling products and services need not be in cash. A common noncash proceed received by a seller is a customer’s promise to pay at a future date, called credit sales. (3) Revenue is measured by the cash received plus the cash value of any other items received.

The business entity principle means that a business is accounted for separately from other business entities, including its owner. The reason for this principle is that separate information about each business is necessary for good decisions. A business entity can take one of three legal forms: proprietorship, partnership, or corporation.

1. A sole proprietorship, or simply proprietorship, is a business owned by one person. No special legal requirements must be met to start a proprietorship. It is a separate entity for accounting purposes, but it is not a separate legal entity from its owner. This means, for example, that a court can order an owner to sell personal belongings to pay a proprietorship’s debt. This unlimited liability of a proprietorship is a disadvantage. However, an advantage is that a proprietorship’s income is not subject to a business income tax but is instead reported and taxed on the owner’s personal income tax return. Proprietorship characteristics are summarized in Exhibit 1.8, including those for partnerships and corporations.

2. A partnership is a business owned by two or more people, called partners. Like a proprietorship, no special legal requirements must be met in starting a partnership. The only requirement is an agreement between partners to run a business together. The agreement can be either oral or written and usually indicates how income and losses are to be shared. A partnership, like a proprietorship, is not legally separate from its owners. This means that each partner’s share of profits is reported and taxed on that partner’s tax return. It also means unlimited liability for its partners. However, at least three types of partnerships limit liability. A limited partnership (LP) includes a general partner(s) with unlimited liability and a limited partner(s) with liability restricted to the amount invested. A limited liability partnership (LLP) restricts partners’
liabilities to their own acts and the acts of
individuals under their control. This protects an
innocent partner from the negligence of another
partner, yet all partners remain responsible
for partnership debts. A limited liability com-
pany (LLC), offers the limited liability of a
corporation and the tax treatment of a partner-
ship (and proprietorship). Most proprietor-
ships and partnerships are now organized as
LLCs.

3. A corporation is a business legally separate
from its owners, meaning it is responsible for
its own acts and its own debts. Separate legal status means that a corporation can con-
duct business with the rights, duties, and responsibilities of a person. A corporation acts
through its managers, who are its legal agents. Separate legal status also means that its
owners, who are called shareholders (or stockholders), are not personally liable for
corporate acts and debts. This limited liability is its main advantage. A main disadvan-
tage is what’s called double taxation—meaning that (1) the corporation income is taxed
and (2) any distribution of income to its owners through dividends is taxed as part of
the owners’ personal income, usually at the 15% rate. (Note: For lower income taxpayers,
the dividend tax is less than 15%, and in some cases zero.) An exception to this is
an S corporation, a corporation with certain
characteristics that give it a tax status that
removes its corporate income tax. Owners of
S corporations report their share of corporate
income with their personal income. Ownership of corporations is divided into
units called shares or stock. When a corpora-
tion issues only one class of stock, we call it common stock (or capital stock).

Sarbanes–Oxley

Congress passed the Sarbanes–Oxley Act, also called SOX, to help curb financial abuses at
companies that issue their stock to the public. SOX requires that these public companies ap-
ply both accounting oversight and stringent internal controls. The desired results include more
transparency, accountability, and truthfulness in reporting transactions.

Compliance with SOX requires extensive documentation and verification of internal controls
and increased emphasis on internal control effectiveness. Failure to comply can yield financial
penalties, stock market delisting, and criminal prosecution of executives. Management must is-
sue a report stating that internal controls are effective. CEOs and CFOs who knowingly sign
off on bogus accounting reports risk millions of dollars in fines and up to 10 years in prison.
Auditors also must verify the effectiveness of internal controls.

Point: An audit examines whether
financial statements are prepared using
GAAP. It does not attest to the absolute
accuracy of the statements.

Point: BusinessWeek (2005) reports
that external audit costs run about
$35,000 for startups, up from $15,000
pre-SOX.

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Proprietorship</th>
<th>Partnership</th>
<th>Corporation</th>
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</thead>
<tbody>
<tr>
<td>Business entity</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Legal entity</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Limited liability</td>
<td>no*</td>
<td>no*</td>
<td>yes</td>
</tr>
<tr>
<td>Unlimited life</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Business taxed</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>One owner allowed</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
</tbody>
</table>

* Proprietorships and partnerships that are set up as LLCs provide limited liability.
1. Accounting in Business Text

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Chapter 1 Accounting in Business

Quick Check

7. What three-step guidelines can help people make ethical decisions?
8. Why are ethics and social responsibility valuable to organizations?
9. Why are ethics crucial in accounting?
10. Who sets U.S. accounting rules?
11. How are U.S. companies affected by international accounting standards?
12. How are the objectivity and cost principles related?
13. Why is the business entity principle important?
14. Why is the revenue recognition principle important?
15. What are the three basic forms of business organization?
16. Identify the owners of corporations and the terminology for ownership units.

Answers—p. 26

Transaction Analysis and the Accounting Equation

To understand accounting information, we need to know how an accounting system captures relevant data about transactions, and then classifies, records, and reports data.

Accounting Equation

The accounting system reflects two basic aspects of a company: what it owns and what it owes. **Assets** are resources with future benefits that are owned or controlled by a company. Examples are cash, supplies, equipment, and land. The claims on a company’s assets—what it owes—are separated into owner and nonowner claims. **Liabilities** are what a company owes its nonowners (creditors) in future payments, products, or services. **Equity** (also called owner’s equity or capital) refers to the claims of its owner(s). Together, liabilities and equity are the source of funds to acquire assets. The relation of assets, liabilities, and equity is reflected in the following **accounting equation**:

**Assets = Liabilities + Equity**

Liabilities are usually shown before equity in this equation because creditors’ claims must be paid before the claims of owners. (The terms in this equation can be rearranged; for example, Assets = Liabilities = Equity.) The accounting equation applies to all transactions and events, to all companies and forms of organization, and to all points in time. For example, Best Buy’s assets equal $10,294, its liabilities equal $5,845, and its equity equals $4,449 ($ in millions). Let’s now look at the accounting equation in more detail.

**Assets** Assets are resources owned or controlled by a company. These resources are expected to yield future benefits. Examples are Web servers for an online services company, musical instruments for a rock band, and land for a vegetable grower. The term **receivable** is used to refer to an asset that promises a future inflow of resources. A company that provides a service or product on credit is said to have an account receivable from that customer.

**Liabilities** Liabilities are creditors’ claims on assets. These claims reflect obligations to provide assets, products or services to others. The term **payable** refers to a liability that promises a future outflow of resources. Examples are wages payable to workers, accounts payable to suppliers, notes payable to banks, and taxes payable to the government.

**Equity** Equity is the owner’s claim on assets. Equity is equal to assets minus liabilities. This is the reason equity is also called net assets or residual equity.

Equity for a noncorporate entity—commonly called owner’s equity—increases and decreases as follows: owner investments and revenues increase equity, whereas owner withdrawals and expenses decrease equity. **Owner investments** are assets an owner puts into the company and
are included under the generic account **Owner, Capital.** **Revenues** increase equity and are the assets earned from a company’s earnings activities. Examples are consulting services provided, sales of products, facilities rented to others, and commissions from services. **Owner withdrawals** are assets an owner takes from the company for personal use. **Expenses** decrease equity and are the cost of assets or services used to earn revenues. Examples are costs of employee time, use of supplies, and advertising, utilities, and insurance services from others. In sum, equity is the accumulated revenues and owner investments less the accumulated expenses and withdrawals since the company began. This breakdown of equity yields the following expanded accounting equation.

![Equation](Assets = Liabilities + Owner, Capital − Owner, Withdrawals + Revenues − Expenses)

**Net income** occurs when revenues exceed expenses. Net income increases equity. A **net loss** occurs when expenses exceed revenues, which decreases equity.

### Transaction Analysis

Business activities can be described in terms of transactions and events. **External transactions** are exchanges of value between two entities, which yield changes in the accounting equation. **Internal transactions** are exchanges within an entity; they can also affect the accounting equation. An example is a company’s use of its supplies, which are reported as expenses when used. **Events** refer to those happenings that affect an entity’s accounting equation and can be reliably measured. They include business events such as changes in the market value of certain assets and liabilities, and natural events such as floods and fires that destroy assets and create losses. They do not include, for example, the signing of service or product contracts, which by themselves do not impact the accounting equation.

This section uses the accounting equation to analyze 11 selected transactions and events of FastForward, a start-up consulting business, in its first month of operations. Remember that each transaction and event leaves the equation in balance and that assets **always** equal the sum of liabilities and equity.

#### Transaction 1: Investment by Owner

On December 1, Chuck Taylor forms a consulting business, focused on assessing the performance of athletic footwear and accessories, which he names FastForward. He sets it up as a proprietorship. Taylor owns and manages the business. The marketing plan for the business is to focus primarily on consulting with sports clubs, amateur athletes, and others who place orders for athletic footwear and accessories with manufacturers. Taylor personally invests $30,000 cash in the new company and deposits the cash in a bank account opened under the name of FastForward. After this transaction, the cash (an asset) and the owner’s equity each equal $30,000. The source of increase in equity is the owner’s investment, which is included in the column titled C. Taylor, Capital. (Owner investments are always included under the title “Owner name,” Capital.) The effect of this transaction on FastForward is reflected in the accounting equation as follows.

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>$30,000</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**Decision Insight**

**Point:** Revenues and owner investments increase equity. Expenses and owner withdrawals decrease equity.

**Point:** Revenues usually result from product sales, services provided, property rentals, and money lending.

**Point:** There are 3 basic types of company operations: (1) **Services**—providing services for profit, (2) **Merchandisers**—buying products and reselling them for profit, and (3) **Manufacturers**—creating products and selling them for profit.
Transaction 2: Purchase Supplies for Cash  
FastForward uses $2,500 of its cash to buy supplies of brand name athletic footwear for performance testing over the next few months. This transaction is an exchange of cash, an asset, for another kind of asset, supplies. It merely changes the form of assets from cash to supplies. The decrease in cash is exactly equal to the increase in supplies. The supplies of athletic footwear are assets because of the expected future benefits from the test results of their performance. This transaction is reflected in the accounting equation as follows:

\[
\begin{array}{c}
\text{Assets} = \text{Liabilities} + \text{Equity} \\
\text{Cash} + \text{Supplies} = \text{C. Taylor, Capital}
\end{array}
\]

\[
\begin{array}{c}
\text{Old Bal.} \\
30,000 + 0 = 30,000 \\
(2) \\
-2,500 + 2,500 = 0 \\
\text{New Bal.} \\
27,500 + 2,500 = 30,000
\end{array}
\]

Transaction 3: Purchase Equipment for Cash  
FastForward spends $26,000 to acquire equipment for testing athletic footwear. Like transaction 2, transaction 3 is an exchange of one asset, cash, for another asset, equipment. The equipment is an asset because of its expected future benefits from testing athletic footwear. This purchase changes the makeup of assets but does not change the asset total. The accounting equation remains in balance.

\[
\begin{array}{c}
\text{Assets} = \text{Liabilities} + \text{Equity} \\
\text{Cash} + \text{Supplies} + \text{Equipment} = \text{C. Taylor, Capital}
\end{array}
\]

\[
\begin{array}{c}
\text{Old Bal.} \\
27,500 + 2,500 + 26,000 = 30,000 \\
(3) \\
-26,000 + 2,500 + 26,000 = 30,000 \\
\text{New Bal.} \\
1,500 + 2,500 + 26,000 = 30,000
\end{array}
\]

Transaction 4: Purchase Supplies on Credit  
Taylor decides he needs more supplies of athletic footwear and accessories. These additional supplies total $7,100, but as we see from the accounting equation in transaction 3, FastForward has only $1,500 in cash. Taylor arranges to purchase them on credit from CalTech Supply Company. Thus, FastForward acquires supplies in exchange for a promise to pay for them later. This purchase increases assets by $7,100 in supplies, and liabilities (called accounts payable to CalTech Supply) increase by the same amount. The effects of this purchase follow:

\[
\begin{array}{c}
\text{Assets} = \text{Liabilities} + \text{Equity} \\
\text{Cash} + \text{Supplies} + \text{Equipment} = \text{Accounts Payable} + \text{C. Taylor, Capital}
\end{array}
\]

\[
\begin{array}{c}
\text{Old Bal.} \\
1,500 + 2,500 + 26,000 = 30,000 \\
(4) \\
+ 7,100 + 7,100 = 37,100 \\
\text{New Bal.} \\
1,500 + 9,600 + 26,000 = 37,100
\end{array}
\]

Example: If FastForward pays $500 cash in transaction 4, how does this partial payment affect the liability to CalTech? What would be FastForward’s cash balance? Answers: The liability to CalTech would be reduced to $6,600 and the cash balance would be reduced to $1,000.

Transaction 5: Provide Services for Cash  
FastForward earns revenues by consulting with clients about test results on athletic footwear and accessories. It earns net income only if its revenues are greater than its expenses incurred in earning them. In one of its first jobs, FastForward provides consulting services to an athletic club and immediately collects $4,200 cash. The accounting equation reflects this increase in cash of $4,200 and in equity of $4,200. This increase in equity is identified in the far right column under Revenues because the cash received is earned by providing consulting services.
Transaction 8: Provide Services and Facilities for Credit  FastForward provides consulting services of $1,600 and rents its test facilities for $300 to an amateur sports club. The rental involves allowing club members to try recommended footwear and accessories at FastForward’s testing grounds. The sports club is billed for the $1,900 total. This transaction results in a new asset, called accounts receivable, from this client. It also yields an increase in equity from the two revenue components reflected in the Revenues column of the accounting equation:

Transaction 9: Receipt of Cash from Accounts Receivable  The client in transaction 8 (the amateur sports club) pays $1,900 to FastForward 10 days after it is billed for consulting services. This transaction 9 does not change the total amount of assets and does not affect liabilities or equity. It converts the receivable (an asset) to cash (another asset). It does
not create new revenue. Revenue was recognized when FastForward rendered the services in transaction 8, not when the cash is now collected. This emphasis on the earnings process instead of cash flows is a goal of the revenue recognition principle and yields useful information to users. The new balances follow:

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Accounts Receivable</th>
<th>Supplies</th>
<th>Equipment</th>
<th>Assets =</th>
<th>Liabilities =</th>
<th>Equity =</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old Bal.</td>
<td>$4,000</td>
<td>$1,900</td>
<td>$9,600</td>
<td>$26,000</td>
<td>$41,500</td>
<td>$1,900</td>
<td>$1,700</td>
</tr>
<tr>
<td>(9)</td>
<td>+1,900</td>
<td>-1,900</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Bal.</td>
<td>$5,900</td>
<td>$0</td>
<td>$9,600</td>
<td>$26,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Transaction 10: Payment of Accounts Payable

FastForward pays CalTech Supply $900 cash as partial payment for its earlier $7,100 purchase of supplies (transaction 4), leaving $6,200 unpaid. The accounting equation shows that this transaction decreases FastForward’s cash by $900 and decreases its liability to CalTech Supply by $900. Equity does not change. This event does not create an expense even though cash flows out of FastForward (instead the expense is recorded when FastForward derives the benefits from these supplies).

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Accounts Receivable</th>
<th>Supplies</th>
<th>Equipment</th>
<th>Assets =</th>
<th>Liabilities =</th>
<th>Equity =</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old Bal.</td>
<td>$5,900</td>
<td>$0</td>
<td>$9,600</td>
<td>$26,000</td>
<td>$40,600</td>
<td>$900</td>
<td>$1,700</td>
</tr>
<tr>
<td>(10)</td>
<td>-900</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Bal.</td>
<td>$5,000</td>
<td>$0</td>
<td>$9,600</td>
<td>$26,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Transaction 11: Withdrawal of Cash by Owner

The owner of FastForward withdraws $200 cash for personal use. Withdrawals (decreases in equity) are not reported as expenses because they are not part of the company’s earnings process. Since withdrawals are not company expenses, they are not used in computing net income.

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Accounts Receivable</th>
<th>Supplies</th>
<th>Equipment</th>
<th>Assets =</th>
<th>Liabilities =</th>
<th>Equity =</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old Bal.</td>
<td>$5,000</td>
<td>$0</td>
<td>$9,600</td>
<td>$26,000</td>
<td>$40,400</td>
<td>$200</td>
<td>$1,700</td>
</tr>
<tr>
<td>(11)</td>
<td>-200</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Bal.</td>
<td>$4,800</td>
<td>$0</td>
<td>$9,600</td>
<td>$26,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Summary of Transactions

We summarize in Exhibit 1.9 the effects of these 11 transactions of FastForward using the accounting equation. Two points should be noted. First, the accounting equation remains in balance after each transaction. Second, transactions can be analyzed by their effects on components of the accounting equation. For example, in transactions 2, 3, and 9, one asset increased while another decreased by equal amounts.
Exhibit 1.9
Summary of Transactions Using the Accounting Equation

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts Payable</td>
<td>C. Taylor, Capital</td>
</tr>
<tr>
<td></td>
<td>+ Supplies</td>
<td></td>
</tr>
<tr>
<td></td>
<td>+ Equipment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>= C. Taylor, Withdrawals</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) $30,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) − 2,500</td>
<td>+ $2,500</td>
<td></td>
</tr>
<tr>
<td>Bal. 27,500</td>
<td>+ 2,500</td>
<td></td>
</tr>
<tr>
<td>(3) − 26,000</td>
<td>+ $26,000</td>
<td></td>
</tr>
<tr>
<td>Bal. 1,500</td>
<td>+ 2,500</td>
<td></td>
</tr>
<tr>
<td>(4) + 7,100</td>
<td>+ 7,100</td>
<td>+ $7,100</td>
</tr>
<tr>
<td>Bal. 1,500</td>
<td>+ 9,600</td>
<td>+ 30,000</td>
</tr>
<tr>
<td>(5) + 4,200</td>
<td></td>
<td>+ $4,200</td>
</tr>
<tr>
<td>Bal. 7,700</td>
<td>+ 9,600</td>
<td>+ 30,000</td>
</tr>
<tr>
<td>(6) − 1,000</td>
<td></td>
<td>− $1,000</td>
</tr>
<tr>
<td>Bal. 4,700</td>
<td>+ 9,600</td>
<td>+ 30,000</td>
</tr>
<tr>
<td>(7) − 700</td>
<td></td>
<td>− 700</td>
</tr>
<tr>
<td>Bal. 4,000</td>
<td>+ 9,600</td>
<td>+ 30,000</td>
</tr>
<tr>
<td>(8) $1,900</td>
<td></td>
<td>+ 1,600</td>
</tr>
<tr>
<td>Bal. 4,000</td>
<td>+ 1,900</td>
<td>+ 1,600</td>
</tr>
<tr>
<td>(9) + 1,900</td>
<td>− 1,900</td>
<td></td>
</tr>
<tr>
<td>Bal. 5,900</td>
<td>+ 0</td>
<td>+ 1,600</td>
</tr>
<tr>
<td>(10) − 900</td>
<td>− 900</td>
<td>+ 1,600</td>
</tr>
<tr>
<td>Bal. 5,000</td>
<td>+ 0</td>
<td>+ 1,600</td>
</tr>
<tr>
<td>(11) − 200</td>
<td></td>
<td>− $200</td>
</tr>
<tr>
<td>Bal. $4,800</td>
<td>$0</td>
<td>− $200</td>
</tr>
</tbody>
</table>

Quick Check

17. When is the accounting equation in balance, and what does that mean?
18. How can a transaction not affect any liability and equity accounts?
19. Describe a transaction increasing equity and one decreasing it.
20. Identify a transaction that decreases both assets and liabilities.

Financial Statements

This section shows how financial statements are prepared from the analysis of business transactions. The four financial statements and their purposes are:

1. **Income statement**—describes a company’s revenues and expenses along with the resulting net income or loss over a period of time due to earnings activities.

2. **Statement of owner’s equity**—explains changes in equity from net income (or loss) and from any owner investments and withdrawals over a period of time.

3. **Balance sheet**—describes a company’s financial position (types and amounts of assets, liabilities, and equity) at a point in time.

4. **Statement of cash flows**—identifies cash inflows (receipts) and cash outflows (payments) over a period of time.

We prepare these financial statements using the 11 selected transactions of FastForward. (These statements are technically called *unadjusted*—we explain this in Chapters 2 and 3.)
Income Statement

FastForward’s income statement for December is shown at the top of Exhibit 1.10. Information about revenues and expenses is conveniently taken from the Equity columns of Exhibit 1.9. Revenues are reported first on the income statement. They include consulting revenues of $5,800 from transactions 5 and 8 and rental revenue of $300 from transaction 8. Expenses are reported after revenues. (For convenience in this chapter, we list larger amounts first, but we can sort expenses in different ways.) Rent and salary expenses are from transactions 6 and 7. Expenses reflect the costs to generate the revenues reported. Net income (or loss) is reported at the bottom of the statement and is the amount earned in December. Owner’s investments and withdrawals are not part of income.

Statement of Owner’s Equity

The statement of owner’s equity reports information about how equity changes over the reporting period. This statement shows beginning capital, events that increase it (owner investments and net income), and events that decrease it (withdrawals and net loss). Ending capital is computed in this statement and is carried over and reported on the balance sheet. FastForward’s statement of owner’s equity is the second report in Exhibit 1.10. The beginning capital balance is measured as of the start of business on December 1. It is zero because FastForward did not exist before then. An existing business reports the beginning balance as of the end of the prior reporting period (such as from November 30). FastForward’s statement shows that Taylor’s initial investment created $30,000 of equity. It also shows the $4,400 of net income earned during the period. This links the income statement to the statement of owner’s equity (see line 1). The statement also reports Taylor’s $200 cash withdrawal and FastForward’s end-of-period capital balance.

Balance Sheet

FastForward’s balance sheet is the third report in Exhibit 1.10. This statement refers to FastForward’s financial condition at the close of business on December 31. The left side of the balance sheet lists FastForward’s assets: cash, supplies, and equipment. The upper right side of the balance sheet shows that FastForward owes $6,200 to creditors. Any other liabilities (such as a bank loan) would be listed here. The equity (capital) balance is $34,200. Note the link between the ending balance of the statement of owner’s equity and the equity balance here—see line 2. (This presentation of the balance sheet is called the account form: assets on the left and liabilities and equity on the right. Another presentation is the report form: assets on top, followed by liabilities and then equity at the bottom. Either presentation is acceptable.)

Statement of Cash Flows

FastForward’s statement of cash flows is the final report in Exhibit 1.10. The first section reports cash flows from operating activities. It shows the $6,100 cash received from clients and the cash paid for supplies, rent, and employee salaries. Outflows are in parentheses to denote subtraction. Net cash provided by operating activities for December is $1,000. If cash paid exceeded cash received, we would call it “cash used by operating activities.” The second section reports investing activities, which involve buying and selling assets such as land and equipment that are held for long-term use (typically more than one year). The only investing activity is the $26,000 purchase of equipment. The third section shows cash flows from financing activities, which include the long-term borrowing and repaying of cash from lenders and the owner’s cash investments and withdrawals. FastForward reports $30,000 from the owner’s
Exhibit 1.10
Financial Statements and Their Links

Point: A statement’s heading identifies the company, the statement title, and the date or time period.

Point: Arrow lines show how the statements are linked. 1 Net income is used to compute equity. 2 Ending capital is used to prepare the balance sheet. 3 Cash from the balance sheet is used to reconcile the statement of cash flows.

Point: The income statement, the statement of owner’s equity, and the statement of cash flows are prepared for a period of time. The balance sheet is prepared as of a point in time.

Point: A single ruled line denotes an addition or subtraction. Final totals are double underlined. Negative amounts are often in parentheses.
Chapter 1  Accounting in Business

initial investment and the $200 cash withdrawal. The net cash effect of all transactions is a $29,800 cash inflow. The final part of the statement shows FastForward increased its cash balance by $4,800 in December. Since it started with no cash, the ending balance is also $4,800—see line 3.

Quick Check

21. Explain the link between the income statement and the statement of owner’s equity.

22. Describe the link between the balance sheet and the statement of owner’s equity.

23. Discuss the three major sections of the statement of cash flows.

Decision Analysis (a section at the end of each chapter) introduces and explains ratios helpful in decision making using real company data. Instructors can skip this section and cover all ratios in Chapter 17.

A3 Compute and interpret return on assets.

Exhibit 1.11

Return on Assets

Net income is from the annual income statement, and average total assets is computed by adding the beginning and ending amounts for that same period and dividing by 2. To illustrate, Best Buy reports net income of $984 million in 2005. At the beginning of fiscal 2005, its total assets are $8,652 million and at the end of fiscal 2005, they total $10,294 million. Best Buy’s return on assets for 2005 is:

\[
\text{Return on assets} = \frac{\text{Net income}}{\text{Average total assets}}
\]

Is a 10.4% return on assets good or bad for Best Buy? To help answer this question, we compare (benchmark) Best Buy’s return with its prior performance, the returns of competitors (such as Circuit City, RadioShack, and CompUSA), and the returns from alternative investments. Best Buy’s return for each of the prior five years is in the second column of Exhibit 1.12, which ranges from 1.3% to 10.4%. These returns show an increase in its productive use of assets in recent years. We also compute Circuit City’s returns in the third column of Exhibit 1.12. In four of the five years, Best Buy’s return exceeds Circuit City’s, and its average return is higher for this period. We also compare Best Buy’s return to the normal return for similar merchandisers of electronic products (fourth column). Industry averages are available from services such as Dun & Bradstreet’s Industry Norms and Key Ratios and Robert Morris Associates’ Annual Statement Studies. When compared to the industry, Best Buy performs well.

Business Owner  You own a small winter ski resort that earns a 21% return on its assets. An opportunity to purchase a winter ski equipment manufacturer is offered to you. This manufacturer earns a 19% return on its assets. The industry return for this manufacturer is 14%. Do you purchase this manufacturer?
After several months of planning, Jasmine Worthy started a haircutting business called Expressions. The following events occurred during its first month:

a. On August 1, Worthy invested $3,000 cash and $15,000 of equipment in Expressions.
b. On August 2, Expressions paid $600 cash for furniture for the shop.
c. On August 3, Expressions paid $500 cash to rent space in a strip mall for August.
d. On August 4, it purchased $1,200 of equipment on credit for the shop (using a long-term note payable).
e. On August 5, Expressions opened for business. Cash received from services provided in the first week and a half of business (ended August 15) is $825.
f. On August 15, it provided $100 of haircutting services on account.
g. On August 17, it received a $100 check for services previously rendered on account.
h. On August 17, it paid $125 cash to an assistant for working during the grand opening.
i. Cash received from services provided during the second half of August is $930.
j. On August 31, it paid a $400 installment toward principal on the note payable entered into on August 4.
k. On August 31, Worthy made a $900 cash withdrawal for personal use.

Required

1. Arrange the following asset, liability, and equity titles in a table similar to the one in Exhibit 1.9:
   Cash; Accounts Receivable; Furniture; Store Equipment; Note Payable; J. Worthy, Capital; J. Worthy, Withdrawals; Revenues; and Expenses. Show the effects of each transaction using the accounting equation.
2. Prepare an income statement for August.
3. Prepare a statement of owner’s equity for August.
4. Prepare a balance sheet as of August 31.
5. Prepare a statement of cash flows for August.
6. Determine the return on assets ratio for August.

Planning the Solution

- Set up a table like Exhibit 1.9 with the appropriate columns for accounts.
- Analyze each transaction and show its effects as increases or decreases in the appropriate columns.
  Be sure the accounting equation remains in balance after each transaction.
- Prepare the income statement, and identify revenues and expenses. List those items on the statement, compute the difference, and label the result as net income or net loss.
- Use information in the Equity columns to prepare the statement of owner’s equity.
- Use information in the last row of the transactions table to prepare the balance sheet.
- Prepare the statement of cash flows; include all events listed in the Cash column of the transactions table. Classify each cash flow as operating, investing, or financing.
- Calculate return on assets by dividing net income by average assets.
Solution to Demonstration Problem

1. Accounting in Business Text

.expression

EXPRESSIONS

Income Statement
For Month Ended August 31

<table>
<thead>
<tr>
<th>Revenues</th>
<th>$1,855</th>
</tr>
</thead>
<tbody>
<tr>
<td>Haircutting services revenue</td>
<td></td>
</tr>
</tbody>
</table>

.expression

EXPRESSIONS

Statement of Owner's Equity
For Month Ended August 31

<table>
<thead>
<tr>
<th>J.Worthy, Capital, August 1*</th>
<th>$0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plus: Investments by owner</td>
<td>$18,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$1,230</td>
</tr>
</tbody>
</table>

* If Expressions had been an existing business from a prior period, the beginning capital balance would equal the Capital account balance from the end of the prior period.
4.

**EXPRESSIONS**

**Balance Sheet**

**August 31**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$2,330</td>
</tr>
<tr>
<td>Furniture</td>
<td>600</td>
</tr>
<tr>
<td>Store equipment</td>
<td>16,200</td>
</tr>
<tr>
<td>Total assets</td>
<td>$19,130</td>
</tr>
<tr>
<td>Note payable</td>
<td>$800</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>J.Worthy, Capital</td>
<td>18,330</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$19,130</td>
</tr>
</tbody>
</table>

5.

**EXPRESSIONS**

**Statement of Cash Flows**

**For Month Ended August 31**

- Cash flows from operating activities
  - Cash received from customers: $1,855
  - Cash paid for rent: (500)
  - Cash paid for wages: (125)
  - Net cash provided by operating activities: $1,230

- Cash flows from investing activities
  - Cash paid for furniture: (600)

- Cash flows from financing activities
  - Cash investments by owner: 3,000
  - Cash withdrawals by owner: (900)
  - Partial repayment of (long-term) note payable: (400)
  - Net cash provided by financing activities: 1,700

- Net increase in cash: $2,330
- Cash balance, August 1: 0
- Cash balance, August 31: $2,330

6. Return on assets = \( \frac{\text{Net income}}{\text{Average assets}} \)

\[
= \frac{1,230}{(18,000 + 19,130)/2} = \frac{1,230}{18,565} = 6.63\%
\]

* Uses the initial $18,000 investment as the beginning balance for the startup period only.

---

**APPENDIX**

**Return and Risk Analysis**

This appendix explains return and risk analysis and its role in business and accounting.

Net income is often linked to return. Return on assets (ROA) is stated in ratio form as income divided by assets invested. For example, banks report return from a savings account in the form of an interest return such as 4%. If we invest in a savings account or in U.S. Treasury bills, we expect a return of around 2% to 7%. We could also invest in a company’s stock, or even start our own business. How do we decide among these investment options? The answer depends on our trade-off between return and risk.
Risk is the uncertainty about the return we will earn. All business investments involve risk, but some investments involve more risk than others. The lower the risk of an investment, the lower is our expected return. The reason that savings accounts pay such a low return is the low risk of not being repaid with interest (the government guarantees most savings accounts from default). If we buy a share of Nike or any other company, we might obtain a large return. However, we have no guarantee of any return; there is even the risk of loss.

The bar graph in Exhibit 1A.1 shows recent returns for 30-year bonds with different risks. Bonds are written promises by organizations to repay amounts loaned with interest. U.S. Treasury bonds provide a low expected return, but they also offer low risk since they are backed by the U.S. government. High-risk corporate bonds offer a much larger potential return but with much higher risk.

The trade-off between return and risk is a normal part of business. Higher risk implies higher, but riskier, expected returns. To help us make better decisions, we use accounting information to assess both return and risk.

### Exhibit 1A.1
Average Returns for Bonds with Different Risks

<table>
<thead>
<tr>
<th>Type of Bond</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Treasury</td>
<td>5.1%</td>
</tr>
<tr>
<td>Low-risk corporate</td>
<td>5.8%</td>
</tr>
<tr>
<td>Medium-risk corporate</td>
<td>6.9%</td>
</tr>
<tr>
<td>High-risk corporate</td>
<td>7.8%</td>
</tr>
</tbody>
</table>

This appendix explains how the accounting equation is derived from business activities.

There are three major types of business activities: financing, investing, and operating. Each of these requires planning. Planning involves defining an organization’s ideas, goals, and actions. Most public corporations use the Management Discussion and Analysis section in their annual reports to communicate plans. However, planning is not cast in stone. This adds risk to both setting plans and analyzing them.

**Financing** Financing activities provide the means organizations use to pay for resources such as land, buildings, and equipment to carry out plans. Organizations are careful in acquiring and managing financing activities because they can determine success or failure. The two sources of financing are owner and nonowner. Owner financing refers to resources contributed by the owner along with any income the owner leaves in the organization. Nonowner (or creditor) financing refers to resources contributed by creditors (lenders). Financial management is the task of planning how to obtain these resources and to set the right mix between owner and creditor financing.

**Investing** Investing activities are the acquiring and disposing of resources (assets) that an organization uses to acquire and sell its products or services. Assets are funded by an organization’s financing. Organizations differ on the amount and makeup of assets. Some require land and factories to operate. Others need only an office. Determining the amount and type of assets for operations is called asset management.

Invested amounts are referred to as assets. Financing is made up of creditor and owner financing, which hold claims on assets. Creditors’ claims are called liabilities, and the owner’s claim is called equity. This basic equality is called the accounting equation and can be written as: Assets = Liabilities + Equity.

**Operating** Operating activities involve using resources to research, develop, purchase, produce, distribute, and market products and services. Sales and revenues are the inflow of assets from selling
products and services. Costs and expenses are the outflow of assets to support operating activities. Strategic management is the process of determining the right mix of operating activities for the type of organization, its plans, and its market.

Exhibit 1B.1 summarizes business activities. Planning is part of each activity and gives them meaning and focus. Investing (assets) and financing (liabilities and equity) are set opposite each other to stress their balance. Operating activities are below investing and financing activities to show that operating activities are the result of investing and financing.

**Summary**

C1 Explain the purpose and importance of accounting in the information age. Accounting is an information and measurement system that aims to identify, record, and communicate relevant, reliable, and comparable information about business activities. It helps assess opportunities, products, investments, and social and community responsibilities.

C2 Identify users and uses of accounting. Users of accounting are both internal and external. Some users and uses of accounting include (a) managers in controlling, monitoring, and planning; (b) lenders for measuring the risk and return of loans; (c) shareholders for assessing the return and risk of stock; (d) directors for overseeing management; and (e) employees for judging employment opportunities.

C3 Identify opportunities in accounting and related fields. Opportunities in accounting include financial, managerial, and tax accounting. They also include accounting-related fields such as lending, consulting, managing, and planning.

C4 Explain why ethics are crucial to accounting. The goal of accounting is to provide useful information for decision making. For information to be useful, it must be trusted. This demands ethical behavior in accounting.

C5 Explain the meaning of generally accepted accounting principles and define and apply several key accounting principles. Generally accepted accounting principles are a common set of standards applied by accountants. Accounting principles aid in producing relevant, reliable, and comparable information. The business entity principle means that a business is accounted for separately from its owner(s). The objective evidence supports the information. The cost principle means financial statements are based on actual costs incurred. The monetary unit principle assumes transactions can be reflected in money terms. The going-concern principle means financial statements assume the business will continue. The revenue recognition principle means revenue is recognized when earned.

C6 Identify and describe the three major activities in organizations. Organizations carry out three major activities: financing, investing, and operating. Financing is the means used to pay for resources such as land, buildings, and machines. Investing refers to the buying and selling of resources used in acquiring and selling products and services. Operating activities are those necessary for carrying out the organization’s plans.

**Entrepreneur** (p. 11) You should probably form the business as a corporation if potential lawsuits are of prime concern. The corporate form of organization protects your personal property from lawsuits directed at the business and places only the corporation’s resources at risk. A downside of the corporate form is double taxation: The corporation must pay taxes on its income, and you normally must pay taxes on any money distributed to you from the business (even though the corporation already paid taxes on this money). You
should also examine the ethical and socially responsible aspects of starting a business in which you anticipate injuries to others. Formation as an LLC or S corp. should also be explored.

### Retailer (p. 18)
You can use the accounting equation (Assets = Liabilities + Equity) to help identify risky customers to whom you would likely not want to extend credit. A balance sheet provides amounts for each of these key components. The lower a customer’s equity is relative to liabilities, the less likely you would extend credit. A low equity means the business has little value that does not already have creditor claims to it.

### Business Owner (p. 20)
The 19% return on assets for the manufacturer exceeds the 14% industry return (and many others). This is a positive factor for a potential purchase. Also, the purchase of this manufacturer is an opportunity to spread your risk over two businesses as opposed to one. Still, you should hesitate to purchase a business whose return of 19% is lower than your current resort’s return of 21%. You are probably better off directing efforts to increase investment in your resort, assuming you can continue to earn a 21% return.

### Guidance Answers to Quick Checks

<table>
<thead>
<tr>
<th>Quick Checks</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Accounting is an information and measurement system that identifies, records, and communicates relevant information to help people make better decisions.</td>
</tr>
<tr>
<td>2.</td>
<td>Recordkeeping, also called bookkeeping, is the recording of financial transactions and events, either manually or electronically. Recordkeeping is essential to data reliability; but accounting is this and much more. Accounting includes identifying, measuring, recording, reporting, and analyzing business events and transactions.</td>
</tr>
<tr>
<td>3.</td>
<td>Technology offers increased accuracy, speed, efficiency, and convenience in accounting.</td>
</tr>
<tr>
<td>4.</td>
<td>External users of accounting include lenders, shareholders, directors, customers, suppliers, regulators, lawyers, brokers, and the press. Internal users of accounting include managers, officers, and other internal decision makers involved with strategic and operating decisions.</td>
</tr>
<tr>
<td>5.</td>
<td>Internal users (managers) include those from research and development, purchasing, human resources, production, distribution, marketing, and servicing.</td>
</tr>
<tr>
<td>6.</td>
<td>Internal controls are procedures designed to protect assets, ensure reliable accounting reports, promote efficiency, and encourage adherence to company policies. Internal controls are crucial for relevant and reliable information.</td>
</tr>
<tr>
<td>7.</td>
<td>Ethical guidelines are threefold: (1) identify ethical concerns using personal ethics, (2) analyze options considering all good and bad consequences, and (3) make ethical decisions after weighing all consequences.</td>
</tr>
<tr>
<td>8.</td>
<td>Ethics and social responsibility yield good behavior, and they often result in higher income and a better working environment.</td>
</tr>
<tr>
<td>9.</td>
<td>For accounting to provide useful information for decisions, it must be trusted. Trust requires ethics in accounting.</td>
</tr>
<tr>
<td>10.</td>
<td>Two major participants in setting rules include the SEC and the FASB. (Note: Accounting rules reflect society’s needs, not those of accountants or any other single constituency).</td>
</tr>
<tr>
<td>11.</td>
<td>Most U.S. companies are not directly affected by international accounting standards. International standards are put forth as preferred accounting practices. However, stock exchanges and other parties are increasing the pressure to narrow differences in worldwide accounting practices. International accounting standards are playing an important role in that process.</td>
</tr>
<tr>
<td>12.</td>
<td>The objectivity and cost principles are related in that most users consider information based on cost as objective. Information prepared using both principles is considered highly reliable and often relevant.</td>
</tr>
<tr>
<td>13.</td>
<td>Users desire information about the performance of a specific entity. If information is mixed between two or more entities, its usefulness decreases.</td>
</tr>
<tr>
<td>14.</td>
<td>The revenue recognition principle gives preparers guidelines on when to recognize (record) revenue. This is important; for example, if revenue is recognized too early, the statements report revenue sooner than it should and the business looks more profitable than it is. The reverse is also true.</td>
</tr>
<tr>
<td>15.</td>
<td>The three basic forms of business organization are sole proprietorships, partnerships, and corporations.</td>
</tr>
<tr>
<td>16.</td>
<td>Owners of corporations are called shareholders (or stockholders). Corporate ownership is divided into units called shares (or stock). The most basic of corporate shares is common stock (or capital stock).</td>
</tr>
<tr>
<td>17.</td>
<td>The accounting equation is: Assets = Liabilities + Equity. This equation is always in balance, both before and after each transaction.</td>
</tr>
<tr>
<td>18.</td>
<td>A transaction that changes the makeup of assets would not affect liability and equity accounts. FastForward’s transactions 2 and 3 are examples. Each exchanges one asset for another.</td>
</tr>
<tr>
<td>19.</td>
<td>Earning revenue by performing services, as in FastForward’s transaction 5, increases equity (and assets). Incurring expenses while servicing clients, such as in transactions 6 and 7, decreases equity (and assets). Other examples include owner investments that increase equity and withdrawals that decrease equity.</td>
</tr>
<tr>
<td>20.</td>
<td>Paying a liability with an asset reduces both asset and liability totals. One example is FastForward’s transaction 10 that reduces a payable by paying cash.</td>
</tr>
<tr>
<td>21.</td>
<td>An income statement reports a company’s revenues and expenses along with the resulting net income or loss. A statement of owner’s equity shows changes in equity, including that from net income or loss. Both statements report transactions occurring over a period of time.</td>
</tr>
<tr>
<td>22.</td>
<td>The balance sheet describes a company’s financial position (assets, liabilities, and equity) at a point in time. The equity amount in the balance sheet is obtained from the statement of owner’s equity.</td>
</tr>
<tr>
<td>23.</td>
<td>Cash flows from operating activities report cash receipts and payments from the primary business the company engages in. Cash flows from investing activities involve cash transactions from buying and selling long-term assets. Cash flows from financing activities include long-term cash borrowings and repayments to lenders and the cash investments from and withdrawals by the owner.</td>
</tr>
</tbody>
</table>
A list of key terms with page references concludes each chapter (a complete glossary is at the end of the book and on the book’s Website).

### Key Terms

<table>
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<td>Business entity principle</td>
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<td>Corporation</td>
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<td>Events</td>
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<td>Expanded accounting equation</td>
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<td>External transactions</td>
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<td>Financial accounting</td>
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<td>Financial Accounting Standards Board</td>
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<tr>
<td>(IASB)</td>
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<tr>
<td>Liabilities</td>
<td>12</td>
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<tr>
<td>Managerial accounting</td>
<td>6</td>
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<td>Monetary unit principle</td>
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<td>Net income</td>
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<tr>
<td>Net loss</td>
<td>13</td>
</tr>
<tr>
<td>Objectivity principle</td>
<td>9</td>
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<tr>
<td>Owner, Capital</td>
<td>13</td>
</tr>
<tr>
<td>Owner investment</td>
<td>12</td>
</tr>
<tr>
<td>Owner withdrawals</td>
<td>13</td>
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<tr>
<td>Partnership</td>
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<tr>
<td>Proprietary</td>
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<tr>
<td>Recordkeeping</td>
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<td>Return</td>
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<tr>
<td>Return on assets</td>
<td>20</td>
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<tr>
<td>Revenue recognition principle</td>
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<td>Revenues</td>
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<td>Risk</td>
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<td>Sarbanes–Oxley Act</td>
<td>11</td>
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<td>Securities and Exchange Commission (SEC)</td>
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<tr>
<td>Shareholders</td>
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<tr>
<td>Shares</td>
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<tr>
<td>Sole proprietorship</td>
<td>10</td>
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<td>Statement of cash flows</td>
<td>17</td>
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<td>Statement of owner’s equity</td>
<td>17</td>
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<tr>
<td>Stock</td>
<td>11</td>
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<tr>
<td>Stockholders</td>
<td>11</td>
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<tr>
<td>Withdrawal</td>
<td>13</td>
</tr>
</tbody>
</table>

### Multiple Choice Quiz

Multiple Choice Quizzes A and B are available at the book’s Website.

1. A building is offered for sale at $500,000 but is currently assessed at $400,000. The purchaser of the building believes the building is worth $475,000, but ultimately purchases the building for $450,000. The purchaser records the building at:
   a. $50,000
   b. $400,000
   c. $450,000
   d. $475,000
   e. $500,000

2. On December 30, 2006, KPMG signs a $150,000 contract to provide accounting services to one of its clients in 2007. KPMG has a December 31 year-end. Which accounting principle requires KPMG to record the accounting services revenue from this client in 2007 and not 2006?
   a. Business entity principle
   b. Revenue recognition principle
   c. Monetary unit principle
   d. Cost principle
   e. Going-concern principle

3. If the assets of a company increase by $100,000 during the year and its liabilities increase by $35,000 during the same year, then the change in equity of the company during the year must have been:
   a. An increase of $135,000.
   b. A decrease of $135,000.
   c. A decrease of $65,000.
   d. An increase of $65,000.
   e. An increase of $100,000.

4. A company borrows $50,000 cash from Third National Bank. How does this transaction affect the accounting equation for this company?
   a. Assets increase by $50,000; liabilities increase by $50,000; no effect on equity.
   b. Assets increase by $50,000; no effect on liabilities; equity increases by $50,000.
   c. Assets increase by $50,000; liabilities decrease by $50,000; no effect on equity.
   d. No effect on assets; liabilities increase by $50,000; equity increases by $50,000.
   e. No effect on assets; liabilities increase by $50,000; equity decreases by $50,000.

5. Geek Squad performs services for a customer and bills the customer for $500. How would Geek Squad record this transaction?
   a. Accounts receivable increase by $500; revenues increase by $500.
   b. Cash increases by $500; revenues increase by $500.
   c. Accounts receivable increase by $500; revenues decrease by $500.
   d. Accounts receivable increase by $500; accounts payable increase by $500.
   e. Accounts payable increase by $500; revenues increase by $500.
## Discussion Questions

1. What is the purpose of accounting in society?
2. Technology is increasingly used to process accounting data. Why then must we study and understand accounting?
3. Identify at least four kinds of external users and describe how they use accounting information.
4. What are at least three questions business owners and managers might be able to answer by looking at accounting information?
5. Identify three actual businesses that offer services and three actual businesses that offer products.
6. Describe the internal role of accounting for organizations.
7. Identify three types of services typically offered by accounting professionals.
8. What type of accounting information might be useful to the marketing managers of a business?
9. Why is accounting described as a service activity?
10. What are some accounting-related professions?
11. How do ethics rules affect auditors’ choice of clients?
12. What work do tax accounting professionals perform in addition to preparing tax returns?
13. What does the objectivity principle imply for information reported in financial statements? Why?
14. A business reports its own office stationery on the balance sheet at its $400 cost, although it cannot be sold for more than $10 as scrap paper. Which accounting principle(s) justifies this treatment?
15. Why is the revenue recognition principle needed? What does it demand?
16. Describe the three basic forms of business organization and their key characteristics.
17. Define (a) assets, (b) liabilities, (c) equity, and (d) net assets.
18. What events or transactions change equity?
19. Identify the two main categories of accounting principles.
20. What do accountants mean by the term revenue?
21. Define net income and explain its computation.
22. Identify the four basic financial statements of a business.
23. What information is reported in an income statement?
24. Give two examples of expenses a business might incur.
25. What is the purpose of the statement of owner’s equity?
26. What information is reported in a balance sheet?
27. The statement of cash flows reports on what major activities?
28. Define and explain return on assets.
29. Define return and risk. Discuss the trade-off between them.
30. Explain why investing (assets) and financing (liabilities and equity) totals are always equal.
31. Explain why investing (assets) and financing (liabilities and equity) totals are always equal.
32. Refer to the financial statements of Best Buy in Appendix A near the end of the book. To what level of significance are dollar amounts rounded? What time period does its income statement cover?
33. Identify the dollar amounts of Circuit City’s 2005 assets, liabilities, and equity shown in its statements in Appendix A near the end of the book.
34. Access the SEC EDGAR database (www.sec.gov) and retrieve Apple’s 2004 10-K (filed 12-03-2004). Identify its auditor. What responsibility does its independent auditor claim regarding Apple’s financial statements?

### Red numbers denote Discussion Questions that involve decision-making.

### QUICK STUDY

**QS 1-1**

Identifying accounting terms

- **C1**

**QS 1-2**

Identifying accounting users

- **C2**

**QS 1-3**

Explaining internal control

- **C1**

(a) Identify the meaning of these accounting-related acronyms: GAAP, SEC, FASB and IASB. (b) Briefly explain the importance of the knowledge base or organization that is referred to for each of the accounting-related acronyms.

Identify the following users as either external users (E) or internal users (I).

- a. Customers
- b. Suppliers
- c. Brokers
- d. Business press
- e. Managers
- f. District attorney
- g. Shareholders
- h. Lenders
- i. Controllers
- j. FBI and IRS
- k. Consumer group
- l. Sales staff

An important responsibility of many accounting professionals is to design and implement internal control procedures for organizations. Explain the purpose of internal control procedures. Provide two examples of internal controls applied by companies.
Identify at least three main areas of opportunities for accounting professionals. For each area, identify at least three job possibilities linked to accounting.

Accounting professionals must sometimes choose between two or more acceptable methods of accounting for business transactions and events. Explain why these situations can involve difficult matters of ethical concern.

Identify which general accounting principle best describes each of the following practices.

a. In December 2006, Chavez Landscaping received a customer’s order and cash prepayment to install sod at a new house that would not be ready for installation until March 2007. Chavez should record the revenue from the customer order in March 2007, not in December 2006.
b. If $51,000 cash is paid to buy land, the land is reported on the buyer’s balance sheet at $51,000.
c. Jo Keene owns both Sailing Passions and Dockside Supplies. In preparing financial statements for Dockside Supplies, Keene makes sure that the expense transactions of Sailing Passions are kept separate from Dockside’s statements.

d. Total assets of Charter Company equal $700,000 and its equity is $420,000. What is the amount of its liabilities?
e. Total assets of Martin Marine equal $500,000 and its liabilities and equity amounts are equal to each other. What is the amount of its liabilities? What is the amount of its equity?

Use the accounting equation to compute the missing financial statement amounts (a), (b), and (c).

<table>
<thead>
<tr>
<th>Company</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$75,000</td>
<td>$ (a)</td>
<td>$40,000</td>
</tr>
<tr>
<td>2</td>
<td>$ (b)</td>
<td>$25,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>3</td>
<td>$85,000</td>
<td>$20,000</td>
<td>$ (c)</td>
</tr>
</tbody>
</table>

Accounting provides information about an organization’s business transactions and events that both affect the accounting equation and can be reliably measured. Identify at least two examples of both (a) business transactions and (b) business events that meet these requirements.

Use Apple’s September 25, 2004, financial statements, in Appendix A near the end of the book, to answer the following.

a. Identify the dollar amounts of Apple’s 2004 (1) assets, (2) liabilities, and (3) equity.
b. Using Apple’s amounts from part a, verify that Assets = Liabilities + Equity.

Indicate in which financial statement each item would most likely appear: income statement (I), balance sheet (B), statement of owner’s equity (E), or statement of cash flows (CF).

a. Assets  d. Equipment  g. Net decrease (or increase) in cash
b. Cash from operating activities e. Expenses  h. Revenues
c. Withdrawals  f. Liabilities  i. Total liabilities and equity

In a recent year’s financial statements, Home Depot reported the following results. Compute and interpret its return on assets (assume competitors average a 12% return on assets).

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$73,074 million</td>
</tr>
<tr>
<td>Net income</td>
<td>5,001 million</td>
</tr>
<tr>
<td>Average total assets</td>
<td>36,672 million</td>
</tr>
</tbody>
</table>
EXERCISES

Exercise 1-1  
Describing accounting responsibilities

Many accounting professionals work in one of the following three areas.  
A. Financial accounting  
B. Managerial accounting  
C. Tax accounting

Identify the area of accounting that is most involved in each of the following responsibilities.  
1. Internal auditing.  
2. External auditing.  
4. Budgeting.  
5. Investigating violations of tax laws.  
6. Planning transactions to minimize taxes.  
7. Preparing external financial statements.  
8. Reviewing reports for SEC compliance.

Exercise 1-2  
Identifying accounting users and uses

Much of accounting is directed at servicing the information needs of those users that are external to an organization. Identify at least three external users of accounting information and indicate two questions they might seek to answer through their use of accounting information.

Exercise 1-3  
Identifying ethical concerns

Assume the following role and describe a situation in which ethical considerations play an important part in guiding your decisions and actions.  
a. You are a student in an introductory accounting course.  
b. You are a manager with responsibility for several employees.  
c. You are an accounting professional preparing tax returns for clients.  
d. You are an accounting professional with audit clients that are competitors in business.

Exercise 1-4  
Distinguishing business organizations

The following describe several different business organizations. Determine whether the description refers to a sole proprietorship, partnership, or corporation.  
a. Ownership of Zander Company is divided into 1,000 shares of stock.  
b. Wallingford is owned by Trent Malone, who is personally liable for the company’s debts.  
c. Elijah Fong and Ava Logan own Financial Services, a financial services provider. Neither Fong nor Logan has personal responsibility for the debts of Financial Services.  
d. Dylan Bailey and Emma Kayley own Speedy Packages, a courier service. Both are personally liable for the debts of the business.  
e. IBC Services does not have separate legal existence apart from the one person who owns it.  
f. Physio Products does not pay income taxes and has one owner.  
g. Aaliyah Services pays its own income taxes and has two owners.

Exercise 1-5  
Identifying accounting principles

Match each of the numbered descriptions with the principle it best reflects. Indicate your answer by writing the letter for the appropriate principle in the blank space next to each description.  
A. General accounting principle  
B. Cost principle  
C. Business entity principle  
D. Revenue recognition principle  
E. Specific accounting principle  
F. Objectivity principle  
G. Going-concern principle

1. Usually created by a pronouncement from an authoritative body.  
2. Financial statements reflect the assumption that the business continues operating.  
3. Derived from long-used and generally accepted accounting practices.  
4. Every business is accounted for separately from its owner or owners.  
5. Revenue is recorded only when the earnings process is complete.  
6. Information is based on actual costs incurred in transactions.  
7. Financial statement data are supported by evidence other than someone’s opinion or belief.
Exercise 1-6
Learning the language of business
C1–C4

Match each of the numbered descriptions with the term or phrase it best reflects. Indicate your answer by writing the letter for the term or phrase in the blank provided.

A. Audit  C. Ethics  E. SEC  G. Net income
B. GAAP  D. Tax accounting  F. Public accountants  H. IASB

1. Principles that determine whether an action is right or wrong.
2. Accounting professionals who provide services to many clients.
3. An accounting area that includes planning future transactions to minimize taxes paid.
4. An examination of an organization’s accounting system and records that adds credibility to financial statements.
5. Amount a business earns after paying all expenses and costs associated with its sales and revenues.

Exercise 1-7
Using the accounting equation
A1

Determine the missing amount from each of the separate situations a, b, and c below.

<table>
<thead>
<tr>
<th>Assets = Liabilities + Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. ? = $20,000 + $45,000</td>
</tr>
<tr>
<td>b. $100,000 = $34,000 + ?</td>
</tr>
<tr>
<td>c. $154,000 = ? + $40,000</td>
</tr>
</tbody>
</table>

Exercise 1-8
Identifying effects of transactions on the accounting equation
A1 A2

Provide an example of a transaction that creates the described effects for the separate cases a through g.

a. Decreases an asset and decreases equity.
b. Increases an asset and increases a liability.
c. Decreases a liability and increases a liability.
d. Decreases an asset and decreases a liability.
e. Increases an asset and decreases an asset.
f. Increases a liability and decreases equity.
g. Increases an asset and increases equity.

Exercise 1-9
Analysis using the accounting equation
A1 A2

Zen began a new consulting firm on January 5. The accounting equation showed the following balances after each of the company’s first five transactions. Analyze the accounting equation for each transaction and describe each of the five transactions with their amounts.

<table>
<thead>
<tr>
<th>Assets = Liabilities + Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction</td>
</tr>
<tr>
<td>a. $40,000</td>
</tr>
<tr>
<td>b. 38,000</td>
</tr>
<tr>
<td>c. 30,000</td>
</tr>
<tr>
<td>d. 30,000</td>
</tr>
<tr>
<td>e. 31,000</td>
</tr>
</tbody>
</table>

Exercise 1-10
Using the accounting equation
A1 A2

Answer the following questions. (Hint: Use the accounting equation.)

a. Cadence Office Supplies has assets equal to $123,000 and liabilities equal to $47,000 at year-end. What is the total equity for Cadence at year-end?
b. At the beginning of the year, Addison Company’s assets are $300,000 and its equity is $100,000. During the year, assets increase $80,000 and liabilities increase $50,000. What is the equity at the end of the year?
c. At the beginning of the year, Quasar Company’s liabilities equal $70,000. During the year, assets increase by $60,000, and at year-end assets equal $190,000. Liabilities decrease $5,000 during the year. What are the beginning and ending amounts of equity?

Check (c) Beg. equity, $40,000
Exercise 1-11
Identifying effects of transactions using the accounting equation

Leora Holden began a professional practice on June 1 and plans to prepare financial statements at the end of each month. During June, Holden (the owner) completed these transactions.

a. Owner invested $60,000 cash along with equipment that had a $15,000 market value.

b. Paid $1,500 cash for rent of office space for the month.

c. Purchased $10,000 of additional equipment on credit (payment due within 30 days).

d. Completed work for a client and immediately collected the $2,500 cash earned.

e. Completed work for a client and sent a bill for $8,000 to be received within 30 days.

f. Purchased additional equipment for $6,000 cash.

g. Paid an assistant $3,000 cash as wages for the month.

h. Collected $5,000 cash on the amount owed by the client described in transaction e.

i. Paid $10,000 cash to settle the liability created in transaction c.

j. Owner withdrew $1,000 cash for personal use.

Required
Create a table like the one in Exhibit 1.9, using the following headings for columns: Cash; Accounts Receivable; Equipment; Accounts Payable; Holden, Capital; Holden, Withdrawals; Revenues; and Expenses. Then use additions and subtractions to show the effects of the transactions on individual items of the accounting equation. Show new balances after each transaction.

Check Net income, $6,000

Exercise 1-12
Identifying effects of transactions on accounting equation

The following table shows the effects of five transactions (a through e) on the assets, liabilities, and equity of Trista’s Boutique. Write short descriptions of the probable nature of each transaction.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 21,000</td>
<td>+ $ 0</td>
<td>+ $ 0</td>
</tr>
<tr>
<td>$ 1,000</td>
<td>+ $ 4,000</td>
<td>+ $ 1,000</td>
</tr>
<tr>
<td>$ 1,900</td>
<td>+ $ 1,900</td>
<td>- $ 1,000</td>
</tr>
<tr>
<td>$ 17,900</td>
<td>+ $ 0</td>
<td>+ $ 1,900</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 11,360</td>
<td>Cash withdrawals by owner</td>
<td>$ 2,000</td>
</tr>
<tr>
<td>$ 14,000</td>
<td>Consulting fees earned</td>
<td>$ 14,000</td>
</tr>
<tr>
<td>$ 3,250</td>
<td>Rent expense</td>
<td>$ 3,550</td>
</tr>
<tr>
<td>$ 46,000</td>
<td>Salaries expense</td>
<td>$ 7,000</td>
</tr>
<tr>
<td>$ 18,000</td>
<td>Telephone expense</td>
<td>$ 760</td>
</tr>
<tr>
<td>$ 8,500</td>
<td>Miscellaneous expenses</td>
<td>$ 580</td>
</tr>
<tr>
<td>$ 84,000</td>
<td>Owner investments</td>
<td></td>
</tr>
</tbody>
</table>

On October 1, Keisha King organized Real Answers a new consulting firm. On October 31, the company’s records show the following items and amounts. Use this information to prepare an October income statement for the business.

Check Net income, $2,110

Exercise 1-14
Preparing a statement of owner’s equity

Use the information in Exercise 1-13 to prepare an October statement of owner’s equity for Real Answers.
Use the information in Exercise 1-13 (if completed, you can also use your solution to Exercise 1-14) to prepare an October 31 balance sheet for Real Answers.

Use the information in Exercise 1-13 to prepare an October 31 statement of cash flows for Real Answers. Also assume the following:

- The owner’s initial investment consists of $38,000 cash and $46,000 in land.
- The $18,000 equipment purchase is paid in cash.
- The accounts payable balance of $8,500 consists of the $3,250 office supplies purchase and $5,250 in employee salaries yet to be paid.
- The rent, telephone, and miscellaneous expenses are paid in cash.
- No cash has been collected for the $14,000 consulting services provided.

Swiss Group reports net income of $40,000 for 2007. At the beginning of 2007, Swiss Group had $200,000 in assets. By the end of 2007, assets had grown to $300,000. What is Swiss Group’s 2007 return on assets? How would you assess its performance if competitors average a 10% return on assets?

Match each transaction or event to one of the following activities of an organization: financing activities (F), investing activities (I), or operating activities (O).

- An owner contributes resources to the business.
- An organization sells some of its land.
- An organization purchases equipment.
- An organization advertises a new product.
- The organization borrows money from a bank.

The following financial statement information is from five separate companies.

<table>
<thead>
<tr>
<th>Company</th>
<th>December 31, 2006</th>
<th>December 31, 2007</th>
<th>During year 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Assets</td>
<td>Liabilities</td>
<td>Owner investments</td>
</tr>
<tr>
<td>A</td>
<td>$55,000</td>
<td>24,500</td>
<td>6,000</td>
</tr>
<tr>
<td>B</td>
<td>$34,000</td>
<td>21,500</td>
<td>1,400</td>
</tr>
<tr>
<td>C</td>
<td>$24,000</td>
<td>9,000</td>
<td>9,750</td>
</tr>
<tr>
<td>D</td>
<td>$60,000</td>
<td>40,000</td>
<td>?</td>
</tr>
<tr>
<td>E</td>
<td>$119,000</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Assets</td>
<td>$58,000</td>
<td>26,500</td>
<td>6,500</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$29,000</td>
<td>24,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Owner investments</td>
<td>6,000</td>
<td>8,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Net income</td>
<td>8,500</td>
<td>3,500</td>
<td>0</td>
</tr>
<tr>
<td>Owner cash withdrawals</td>
<td>1,400</td>
<td>2,000</td>
<td>11,000</td>
</tr>
</tbody>
</table>
Chapter 1  Accounting in Business

Required

1. Answer the following questions about Company A.
   a. What is the amount of equity on December 31, 2006?
   b. What is the amount of equity on December 31, 2007?
   c. What is the amount of liabilities on December 31, 2007?

2. Answer the following questions about Company B.
   a. What is the amount of equity on December 31, 2006?
   b. What is the amount of equity on December 31, 2007?
   c. What is net income for year 2007?

3. Calculate the amount of assets for Company C on December 31, 2007.


5. Calculate the amount of liabilities for Company E on December 31, 2006.

Problem 1-2A
Identifying effects of transactions on financial statements

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Statement of Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Balance Sheet</td>
<td>Income Statement</td>
<td>Statement of Cash Flows</td>
</tr>
<tr>
<td>1 Owner invests cash in business</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>2 Receives cash for services provided</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Pays cash for employee wages</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Incurs legal costs on credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Borrows cash by signing long-term note payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Owner withdraws cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Buys land by signing note payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Provides services on credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 Buys office equipment for cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Collects cash on receivable from (8)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Problem 1-3A
Preparing an income statement

The following is selected financial information for Elko Energy Company for the year ended December 31, 2007: revenues, $55,000; expenses, $40,000; net income, $15,000.

Required
Prepare the 2007 calendar-year income statement for Elko Energy Company.

Problem 1-4A
Preparing a balance sheet

The following is selected financial information for Amity Company as of December 31, 2007: liabilities, $44,000; equity, $46,000; assets, $90,000.

Required
Prepare the balance sheet for Amity Company as of December 31, 2007.
Following is selected financial information of ABM Co. for the year ended December 31, 2007:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash used by investing activities</td>
<td>$(2,000)</td>
</tr>
<tr>
<td>Net increase in cash</td>
<td>1,200</td>
</tr>
<tr>
<td>Cash used by financing activities</td>
<td>(2,800)</td>
</tr>
<tr>
<td>Cash from operating activities</td>
<td>6,000</td>
</tr>
<tr>
<td>Cash, December 31, 2006</td>
<td>2,300</td>
</tr>
</tbody>
</table>

**Problem 1-5A**
Preparing a statement of cash flows

**Check**
Cash balance, Dec. 31, 2007, $3,500

---

Following is selected financial information for Kasio Co. for the year ended December 31, 2007.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>K. Kasio, Capital, Dec. 31, 2007</td>
<td>$14,000</td>
</tr>
<tr>
<td>Net income</td>
<td>8,000</td>
</tr>
<tr>
<td>K. Kasio, Withdrawals</td>
<td>$1,000</td>
</tr>
<tr>
<td>K. Kasio, Capital, Dec. 31, 2006</td>
<td>7,000</td>
</tr>
</tbody>
</table>

**Problem 1-6A**
Preparing a statement of owner’s equity

**Check**

---

Holden Graham started The Graham Co., a new business that began operations on May 1. Graham Co. completed the following transactions during that first month.

May 1  H. Graham invested $40,000 cash in the business.
1  Rented a furnished office and paid $2,200 cash for May’s rent.
3  Purchased $1,890 of office equipment on credit.
5  Paid $750 cash for this month’s cleaning services.
8  Provided consulting services for a client and immediately collected $5,400 cash.
12  Provided $2,500 of consulting services for a client on credit.
15  Paid $750 cash for an assistant’s salary for the first half of this month.
20  Received $2,500 cash payment for the services provided on May 12.
22  Provided $3,200 of consulting services on credit.
25  Received $3,200 cash payment for the services provided on May 22.
26  Paid $1,890 cash for the office equipment purchased on May 3.
27  Purchased $80 of advertising in this month’s (May) local paper on credit; cash payment is due June 1.
28  Paid $750 cash for an assistant’s salary for the second half of this month.
30  Paid $300 cash for this month’s telephone bill.
30  Paid $280 cash for this month’s utilities.
31  Graham withdrew $1,400 cash for personal use.

**Problem 1-7A**
Analyzing transactions and preparing financial statements

**Check**
(2) Ending balances: Cash, $42,780; Expenses, $5,110
(3) Net income, $5,990; Total assets, $44,670
Chapter 1  Accounting in Business

Problem 1-8A
Analyzing transactions and preparing financial statements
C5  A2  P1

Helga Ander started a new business and completed these transactions during December.

1. Dec. 1 Helga Ander transferred $65,000 cash from a personal savings account to a checking account in the name of Ander Electric.
2. Dec. 2 Rented office space and paid $1,000 cash for the December rent.
3. Dec. 3 Purchased $13,000 of electrical equipment by paying $4,800 cash and agreeing to pay the $8,200 balance in 30 days.
4. Dec. 5 Purchased office supplies by paying $800 cash.
5. Dec. 6 Completed electrical work and immediately collected $1,200 cash for the work.
6. Dec. 8 Purchased $2,530 of office equipment on credit.
7. Dec. 15 Completed electrical work on credit in the amount of $5,000.
8. Dec. 18 Purchased $350 of office supplies on credit.
10. Dec. 24 Billed a client $900 for electrical work completed; the balance is due in 30 days.
11. Dec. 28 Received $5,000 cash for the work completed on December 15.
12. Dec. 29 Paid the assistant’s salary of $1,400 cash for this month.

Required

1. Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Office Supplies; Office Equipment; Electrical Equipment; Accounts Payable; H. Ander, Capital; H. Ander, Withdrawals; Revenues; and Expenses.

2. Use additions and subtractions to show the effects of each transaction on the accounts in the accounting equation. Show new balances after each transaction.

3. Use the increases and decreases in the columns of the table from part 2 to prepare an income statement, a statement of owner’s equity, and a statement of cash flows for the month. Also prepare a balance sheet as of the end of the month.

Analysis Component

4. Assume that the owner investment transaction on December 1 was $49,000 cash instead of $65,000 and that Ander Electric obtained the $16,000 difference by borrowing it from a bank. Explain the effect of this change on total assets, total liabilities, and total equity.

Check

(2) Ending balances: Cash, $59,180; Accounts Payable, $8,550
(3) Net income, $4,160; Total assets, $76,760

Problem 1-9A
Analyzing effects of transactions
C5  P1  A1  A2

Isabel Lopez started Biz Consulting, a new business, and completed the following transactions during its first year of operations.

a. I. Lopez invests $70,000 cash and office equipment valued at $10,000 in the business.

b. Purchased a $150,000 building to use as an office. Biz paid $20,000 in cash and signed a note payable promising to pay the $130,000 balance over the next ten years.

c. Purchased office equipment for $15,000 cash.

d. Purchased $1,200 of office supplies and $1,700 of office equipment on credit.

e. Paid a local newspaper $500 cash for printing an announcement of the office’s opening.

f. Completed a financial plan for a client and billed that client $2,800 for the service.

g. Designed a financial plan for another client and immediately collected a $4,000 cash fee.

h. Lopez withdrew $3,275 cash for personal use.

i. Received a $1,800 cash payment from the client described in transaction f.

j. Made a $700 cash payment on the equipment purchased in transaction d.

k. Paid $1,800 cash for the office secretary’s wages.

Required

1. Create a table like the one in Exhibit 1.9, using the following headings for the columns: Cash; Accounts Receivable; Office Supplies; Office Equipment; Building; Accounts Payable; Notes Payable; I. Lopez, Capital; I. Lopez, Withdrawals; Revenues; and Expenses.

2. Use additions and subtractions to show the effects of these transactions on individual items of the accounting equation. Show new balances after each transaction.

3. Once you have completed the table, determine the company’s net income.

Check

(2) Ending balances: Cash, $34,525; Expenses, $2,300; Notes Payable, $130,000
(3) Net income, $4,500
Coca-Cola and PepsiCo both produce and market beverages that are direct competitors. Key financial figures (in $ millions) for these businesses over the past year follow.

<table>
<thead>
<tr>
<th>Key Figures ($ millions)</th>
<th>Coca-Cola</th>
<th>PepsiCo</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>21,962</td>
<td>29,261</td>
</tr>
<tr>
<td>Net income</td>
<td>4,847</td>
<td>4,212</td>
</tr>
<tr>
<td>Average assets</td>
<td>29,335</td>
<td>26,657</td>
</tr>
</tbody>
</table>

**Required**

1. Compute return on assets for (a) Coca-Cola and (b) PepsiCo.
2. Which company is more successful in its total amount of sales to consumers?
3. Which company is more successful in returning net income from its assets invested?

**Analysis Component**

4. Write a one-paragraph memorandum explaining which company you would invest your money in and why. (Limit your explanation to the information provided.)

Kyzera manufactures, markets, and sells cellular telephones. The average total assets for Kyzera is $250,000. In its most recent year, Kyzera reported net income of $65,000 on revenues of $475,000.

**Required**

1. What is Kyzera’s return on assets?
2. Does return on assets seem satisfactory for Kyzera given that its competitors average a 12% return on assets?
3. What are total expenses for Kyzera in its most recent year?
4. What is the average total amount of liabilities plus equity for Kyzera?

All business decisions involve aspects of risk and return.

**Required**

Identify both the risk and the return in each of the following activities.

1. Investing $2,000 in a 5% savings account.
2. Placing a $2,500 bet on your favorite sports team.
3. Investing $10,000 in Yahoo! stock.
4. Taking out a $7,500 college loan to earn an accounting degree.

A startup company often engages in the following transactions in its first year of operations. Classify these transactions in one of the three major categories of an organization’s business activities.

**F. Financing**
1. Owner investing land in business.
2. Purchasing a building.

**I. Investing**
5. Purchasing equipment.

**O. Operating**
7. Paying for advertising.
8. Paying employee wages.

An organization undertakes various activities in pursuit of business success. Identify an organization’s three major business activities, and describe each activity.
The following financial statement information is from five separate companies.

<table>
<thead>
<tr>
<th></th>
<th>Company V</th>
<th>Company W</th>
<th>Company X</th>
<th>Company Y</th>
<th>Company Z</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>December 31, 2006</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>$54,000</td>
<td>$80,000</td>
<td>$141,500</td>
<td>$92,500</td>
<td>$144,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>25,000</td>
<td>60,000</td>
<td>68,500</td>
<td>51,500</td>
<td>?</td>
</tr>
<tr>
<td><strong>December 31, 2007</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>59,000</td>
<td>100,000</td>
<td>186,500</td>
<td>?</td>
<td>170,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>36,000</td>
<td>?</td>
<td>65,800</td>
<td>42,000</td>
<td>42,000</td>
</tr>
<tr>
<td><strong>During year 2007</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owner investments</td>
<td>5,000</td>
<td>20,000</td>
<td>?</td>
<td>48,100</td>
<td>60,000</td>
</tr>
<tr>
<td>Net income</td>
<td>?</td>
<td>40,000</td>
<td>18,500</td>
<td>24,000</td>
<td>32,000</td>
</tr>
<tr>
<td>Owner cash withdrawals</td>
<td>5,500</td>
<td>2,000</td>
<td>0</td>
<td>20,000</td>
<td>8,000</td>
</tr>
</tbody>
</table>

**Required**

1. Answer the following questions about Company V.
   a. What is the amount of equity on December 31, 2006?
   b. What is the amount of equity on December 31, 2007?
   c. What is the net income or loss for the year 2007?
2. Answer the following questions about Company W.
   a. What is the amount of equity on December 31, 2006?
   b. What is the amount of equity on December 31, 2007?
   c. What is the amount of liabilities on December 31, 2007?
3. Calculate the amount of owner investments for Company X during 2007.
4. Calculate the amount of assets for Company Y on December 31, 2007.
5. Calculate the amount of liabilities for Company Z on December 31, 2006.

**Problem 1-2B**
Identifying effects of transactions on financial statements

Identify how each of the following separate transactions affects financial statements. For the balance sheet, identify how each transaction affects total assets, total liabilities, and total equity. For the income statement, identify how each transaction affects net income. For the statement of cash flows, identify how each transaction affects cash flows from operating activities, cash flows from financing activities, and cash flows from investing activities. For increases, place a “+” in the column or columns. For decreases, place a “−” in the column or columns. If both an increase and a decrease occur, place “+/−” in the column or columns. The first transaction is completed as an example.

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Statement of Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Assets</td>
<td>Total Liab.</td>
<td>Total Equity</td>
</tr>
<tr>
<td>1. Owner invests cash in business</td>
<td>+</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>2. Buys building by signing note payable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Pays cash for salaries incurred</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Provides services for cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Pays cash for rent incurred</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Incurs utilities costs on credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Buys store equipment for cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Owner withdraws cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Provides services on credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Collects cash on receivable from (9)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Problem 1-3B
Preparing an income statement

Selected financial information for Offshore Co. for the year ended December 31, 2007, follows:

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$68,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses</td>
<td>$40,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$28,000</td>
</tr>
</tbody>
</table>

Required
Prepare the 2007 calendar-year income statement for Offshore Co.

Problem 1-4B
Preparing a balance sheet

The following is selected financial information for TLC Company as of December 31, 2007:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>$64,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>$50,000</td>
</tr>
<tr>
<td>Assets</td>
<td>$114,000</td>
</tr>
</tbody>
</table>

Required
Prepare the balance sheet for TLC as of December 31, 2007.

Problem 1-5B
Preparing a statement of cash flows

Selected financial information of HalfLife Co. for the year ended December 31, 2007, follows:

| Cash from investing activities | $1,600 |
| Cash used by operating activities | (3,000) |
| Cash, December 31, 2006         | 1,300  |
| Net increase in cash            | 400    |
| Cash from financing activities  | 1,800  |

Required
Prepare the 2007 calendar-year statement of cash flows for HalfLife Co.

Problem 1-6B
Preparing a statement of owner’s equity

Following is selected financial information of First Act for the year ended December 31, 2007:

| I. Firstact, Capital, Dec. 31, 2007 | $47,000 |
| I. Firstact, Withdrawals            | $7,000  |
| Net income                          | 5,000   |
| I. Firstact, Capital, Dec. 31, 2006 | 49,000  |

Required
Prepare the 2007 calendar-year statement of owner’s equity for First Act.

Problem 1-7B
Analyzing transactions and preparing financial statements

Holly Nikolas launched a new business, Holly’s Maintenance Co., that began operations on June 1. The following transactions were completed by the company during that first month.

<table>
<thead>
<tr>
<th>June</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>H. Nikolas invested $130,000 cash in the business.</td>
</tr>
<tr>
<td>2</td>
<td>Rented a furnished office and paid $6,000 cash for June’s rent.</td>
</tr>
<tr>
<td>4</td>
<td>Purchased $2,400 of equipment on credit.</td>
</tr>
<tr>
<td>6</td>
<td>Paid $1,150 cash for the next week’s advertising of the opening of the business.</td>
</tr>
<tr>
<td>8</td>
<td>Completed maintenance services for a customer and immediately collected $850 cash.</td>
</tr>
<tr>
<td>14</td>
<td>Completed $7,500 of maintenance services for City Center on credit.</td>
</tr>
<tr>
<td>16</td>
<td>Paid $800 cash for an assistant’s salary for the first half of the month.</td>
</tr>
<tr>
<td>20</td>
<td>Received $7,500 cash payment for services completed for City Center on June 14.</td>
</tr>
<tr>
<td>21</td>
<td>Completed $7,900 of maintenance services for Paula’s Beauty Shop on credit.</td>
</tr>
<tr>
<td>24</td>
<td>Completed $675 of maintenance services for Build-It Coop on credit.</td>
</tr>
<tr>
<td>25</td>
<td>Received $7,900 cash payment from Paula’s Beauty Shop for the work completed on June 21.</td>
</tr>
<tr>
<td>26</td>
<td>Made payment of $2,400 cash for the equipment purchased on June 4.</td>
</tr>
<tr>
<td>28</td>
<td>Paid $800 cash for an assistant’s salary for the second half of this month.</td>
</tr>
<tr>
<td>29</td>
<td>Nikolas withdrew $4,000 cash for personal use.</td>
</tr>
<tr>
<td>30</td>
<td>Paid $150 cash for this month’s telephone bill.</td>
</tr>
<tr>
<td>30</td>
<td>Paid $890 cash for this month’s utilities.</td>
</tr>
</tbody>
</table>

Required
1. Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Equipment; Accounts Payable; H. Nikolas, Capital; H. Nikolas, Withdrawals; Revenues; and Expenses.
Chapter 1  Accounting in Business

2. Show the effects of the transactions on the accounts of the accounting equation by recording increases and decreases in the appropriate columns. Do not determine new account balances after each transaction. Determine the final total for each account and verify that the equation is in balance.

3. Prepare a June income statement, a June statement of owner’s equity, a June 30 balance sheet, and a June statement of cash flows.

Truro Excavating Co., owned by Raul Truro, began operations in July and completed the following transactions during that first month.

July 1  R. Truro invested $80,000 cash in the business.
2    Rented office space and paid $700 cash for the July rent.
3    Purchased excavating equipment for $5,000 by paying $1,000 cash and agreeing to pay the $4,000 balance in 30 days.
6    Purchased office supplies for $600 cash.
8    Completed work for a customer and immediately collected $7,600 cash for the work.
10   Purchased $2,300 of office equipment on credit.
15   Completed work for a customer on credit in the amount of $8,200.
17   Purchased $3,100 of office supplies on credit.
23   Paid $2,300 cash for the office equipment purchased on July 10.
25   Billed a customer $5,000 for work completed; the balance is due in 30 days.
28   Received $8,200 cash for the work completed on July 15.
30   Paid an assistant’s salary of $1,560 cash for this month.
31   Paid $295 cash for this month’s utility bill.
31   Truro withdrew $1,800 cash for personal use.

Required
1. Arrange the following asset, liability, and equity titles in a table like Exhibit 1.9: Cash; Accounts Receivable; Office Supplies; Office Equipment; Excavating Equipment; Accounts Payable; R. Truro, Capital; R. Truro, Withdrawals; Revenues; and Expenses.
2. Use additions and subtractions to show the effects of each transaction on the accounts in the accounting equation. Show new balances after each transaction.
3. Use the increases and decreases in the columns of the table from part 2 to prepare an income statement, a statement of owner’s equity, and a statement of cash flows for the month. Also prepare a balance sheet as of the end of the month.

Analysis Component
4. Assume that the $5,000 purchase of excavating equipment on July 3 was financed from an owner investment of another $5,000 cash in the business (instead of the purchase conditions described in the transaction). Explain the effect of this change on total assets, total liabilities, and total equity.
Chapter 1  Accounting in Business

**Required**

1. Create a table like the one in Exhibit 1.9, using the following headings for the columns: Cash; Accounts Receivable; Office Supplies; Office Equipment; Building; Accounts Payable; Notes Payable; N. Mitchell, Capital; N. Mitchell, Withdrawals; Revenues; and Expenses.

2. Use additions and subtractions to show the effects of these transactions on individual items of the accounting equation. Show new balances after each transaction.

3. Once you have completed the table, determine the company’s net income.

**Check**

- (3) Ending balances: Cash, $34,525; Expenses, $2,300; Notes Payable, $130,000
- (3) Net income, $4,500

**Problem 1-10B**

Computing and interpreting return on assets

<table>
<thead>
<tr>
<th>Key Figures ($ millions)</th>
<th>AT&amp;T</th>
<th>Verizon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$34,529</td>
<td>$67,468</td>
</tr>
<tr>
<td>Net income</td>
<td>1,865</td>
<td>3,077</td>
</tr>
<tr>
<td>Average assets</td>
<td>40,396</td>
<td>165,963</td>
</tr>
</tbody>
</table>

**Required**

1. Compute return on assets for (a) AT&T and (b) Verizon.

2. Which company is more successful in the total amount of sales to consumers?

3. Which company is more successful in returning net income from its assets invested?

**Analysis Component**

4. Write a one-paragraph memorandum explaining which company you would invest your money in and why. (Limit your explanation to the information provided.)

**Problem 1-11B**

Determining expenses, liabilities, equity, and return on assets

| Carbondale Company manufactures, markets, and sells snowmobile equipment. The average total assets for Carbondale Company is $3,000,000. In its most recent year, Carbondale reported net income of $200,000 on revenues of $1,400,000. |

<table>
<thead>
<tr>
<th><strong>Required</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. What is Carbondale Company’s return on assets?</td>
</tr>
<tr>
<td>2. Does return on assets seem satisfactory for Carbondale given that its competitors average a 9.5% return on assets?</td>
</tr>
<tr>
<td>3. What are the total expenses for Carbondale Company in its most recent year?</td>
</tr>
<tr>
<td>4. What is the average total amount of liabilities plus equity for Carbondale Company?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Check</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>(3) $1,200,000</td>
</tr>
<tr>
<td>(4) $3,000,000</td>
</tr>
</tbody>
</table>

**Problem 1-12B**

Identifying risk and return

| A startup company often engages in the following activities during its first year of operations. Classify each of the following activities into one of the three major activities of an organization. |

<table>
<thead>
<tr>
<th><strong>F. Financing</strong></th>
<th><strong>I. Investing</strong></th>
<th><strong>O. Operating</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Providing client services.</td>
<td>5. Supervising workers.</td>
<td></td>
</tr>
<tr>
<td>2. Obtaining a bank loan.</td>
<td>6. Owner investing money in business.</td>
<td></td>
</tr>
<tr>
<td>3. Purchasing machinery.</td>
<td>7. Renting office space.</td>
<td></td>
</tr>
</tbody>
</table>
Identify in outline format the three major business activities of an organization. For each of these activities, identify at least two specific transactions or events normally undertaken by the business’s owners or its managers.

**Problem 1-14B**

**Describing organizational activities**

Identify in outline format the three major business activities of an organization. For each of these activities, identify at least two specific transactions or events normally undertaken by the business’s owners or its managers.

**PROBLEM SET C**

Problem Set C is available at the book’s Website to further reinforce and assess your learning.

The serial problem starts in this chapter and continues throughout most chapters of the book. It is most readily solved if you use the Working Papers that accompany this book.

**SERIAL PROBLEM**

**SP 1**

On October 1, 2007, Adriana Lopez launched a computer services company, Success Systems, that is organized as a proprietorship and provides consulting services, computer system installations, and custom program development. Lopez adopts the calendar year for reporting purposes and expects to prepare the company’s first set of financial statements on December 31, 2007.

**Required**

Create a table like the one in Exhibit 1.9 using the following headings for columns: Cash; Accounts Receivable; Computer Supplies; Computer System; Office Equipment; Accounts Payable; A. Lopez, Capital; A. Lopez, Withdrawals; Revenues; and Expenses. Then use additions and subtractions to show the effects of the October transactions for Success Systems on the individual items of the accounting equation. Show new balances after each transaction.

**Oct. 1**

Adriana Lopez invested $75,000 cash, a $25,000 computer system, and $10,000 of office equipment in the business.

**Oct. 3**

Purchased $1,600 of computer supplies on credit from Corvina Office Products.

**Oct. 6**

Billed Easy Leasing $6,200 for services performed in installing a new Web server.

**Oct. 8**

Paid $1,600 cash for the computer supplies purchased from Corvina Office Products on October 3.

**Oct. 10**

Hired Michelle Jones as a part-time assistant for $150 per day, as needed.

**Oct. 12**

Billed Easy Leasing another $1,950 for services performed.

**Oct. 15**

Received $6,200 cash from Easy Leasing toward its account.

**Oct. 17**

Paid $900 cash to repair computer equipment damaged when moving it.

**Oct. 20**

Paid $1,790 cash for an advertisement in the local newspaper.

**Oct. 22**

Received $1,950 cash from Easy Leasing toward its account.

**Oct. 28**

Billed Clark Company $7,300 for services performed.

**Oct. 31**

Paid $1,050 cash for Michelle Jones’s wages for seven days of work this month.

**Oct. 31**

Lopez withdrew $4,000 cash for personal use.

**Check**

Ending balances: Cash, $73,810; Revenues, $15,450; Expenses, $3,740

**BEYOND THE NUMBERS**

**BTN 1-1**

Key financial figures for Best Buy’s fiscal year ended February 26, 2005, follow.

<table>
<thead>
<tr>
<th>Key Figure</th>
<th>In Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$10,294</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>984</td>
</tr>
<tr>
<td>Revenues</td>
<td>27,433</td>
</tr>
</tbody>
</table>
Required

1. What is the total amount of assets invested in Best Buy?
3. How much are total expenses for Best Buy in fiscal year 2005?
4. Does Best Buy’s return on assets seem satisfactory if competitors average a 3.2% return?

Fast Forward

5. Access Best Buy’s financial statements (Form 10-K) for fiscal years ending after February 26, 2005, from its Website (BestBuy.com) or from the SEC Website (www.sec.gov) and compute its return on assets for those fiscal years. Compare the February 26, 2005, fiscal year-end return on assets to any subsequent years’ returns you are able to compute, and interpret the results.

BTN 1-2 Key comparative figures ($ millions) for both Best Buy and Circuit City follow.

<table>
<thead>
<tr>
<th>Key Figure</th>
<th>Best Buy</th>
<th>Circuit City</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities + Equity</td>
<td>$10,294</td>
<td>$3,789</td>
</tr>
<tr>
<td>Net income</td>
<td>984</td>
<td>62</td>
</tr>
<tr>
<td>Revenues and sales</td>
<td>27,433</td>
<td>10,472</td>
</tr>
</tbody>
</table>

Required

1. What is the total amount of assets invested in (a) Best Buy and (b) Circuit City?
2. What is the return on assets for (a) Best Buy and (b) Circuit City? Best Buy’s beginning-year assets equal $8,652 (in millions) and Circuit City’s beginning-year assets equal $3,731 (in millions).
3. How much are expenses for (a) Best Buy and (b) Circuit City?
4. Is return on assets satisfactory for (a) Best Buy and (b) Circuit City? (Assume competitors average a 3.2% return.)
5. What can you conclude about Best Buy and Circuit City from these computations?

BTN 1-3 Craig Thorne works in a public accounting firm and hopes to eventually be a partner. The management of Allnet Company invites Thorne to prepare a bid to audit Allnet’s financial statements. In discussing the audit fee, Allnet’s management suggests a fee range in which the amount depends on the reported profit of Allnet. The higher its profit, the higher will be the audit fee paid to Thorne’s firm.

Required

1. Identify the parties potentially affected by this audit and the fee plan proposed.
2. What are the ethical factors in this situation? Explain.
3. Would you recommend that Thorne accept this audit fee arrangement? Why or why not?
4. Describe some ethical considerations guiding your recommendation.

BTN 1-4 Refer to this chapter’s opening feature about LoveSac. Assume that Shawn Nelson desires to expand his manufacturing facilities to meet customer demand. Shawn and his partners decide they need to meet with his banker to discuss a loan to allow them to expand.

Required

1. Prepare a half-page report outlining the information you would request from Shawn if you were the loan officer.
2. Indicate whether the information you request and your loan decision are affected by the form of business organization for the LoveSac store.

**Required**
1. Item 7 of the 10-K report provides comparative financial highlights of WWE for the years 2000–2004. How would you describe the revenue trend for WWE over this five-year period?
2. Has WWE been profitable (see net income) over this five-year period? Support your answer.

BTN 1-6 Teamwork is important in today’s business world. Successful teams schedule convenient meetings, maintain regular communications, and cooperate with and support their members. This assignment aims to establish support/learning teams, initiate discussions, and set meeting times.

**Required**
1. Form teams and open a team discussion to determine a regular time and place for your team to meet between each scheduled class meeting. Notify your instructor via a memorandum or e-mail message as to when and where your team will hold regularly scheduled meetings.
2. Develop a list of telephone numbers and/or e-mail addresses of your teammates.

The book’s Website provides free and easy access to all articles for every BusinessWeek Activity.

BTN 1-7 BusinessWeek publishes a ranking of the top 1,000 companies based on several performance measures. This issue is called the BusinessWeek Global 1000. Obtain the July 25, 2004, publication of this issue—this book’s Website maintains free access to this article.

**Required**
1. What are the top 10 companies on the basis of market value?
2. Are any of the top 10 companies in the same industry? If yes, identify them.
3. How many of the top 10 based on market capitalization are not U.S. companies? List them.

BTN 1-8 Refer to this chapter’s opening feature about LoveSac. Assume that Shawn Nelson decides to open a new manufacturing facility to meet customer demand. This new company will be called LoveSac Manufacturing.

**Required**
1. LoveSac Manufacturing obtains a $500,000 loan and Shawn contributes $250,000 of his own assets in the new company.
   a. What is the new company’s total amount of liabilities plus equity?
   b. What is the new company’s total amount of assets?
2. If the new company earns $80,000 in net income in the first year of operation, compute its return on asset (assume average assets equal $750,000). Assess its performance if competitors average a 10% return.

Check (2) 10.7%

BTN 1-9 You are to interview a local business owner. (This can be a friend or relative.) Opening lines of communication with members of the business community can provide personal benefits of business networking. If you do not know the owner, you should call ahead to introduce yourself and explain your position as a student and your assignment requirements. You should request a thirty minute appointment for a face-to-face or phone interview to discuss the form of organization and operations of the business. Be prepared to make a good impression.

**Required**
1. Identify and describe the main operating activities and the form of organization for this business.
2. Determine and explain why the owner(s) chose this particular form of organization.
3. Identify any special advantages and/or disadvantages the owner(s) experiences in operating with this form of business organization.
BTN 1-10 Dixons (Dixons-Group.com) is the leading European retailer of consumer electronics and competes globally with both Best Buy and Circuit City. Key financial figures for Dixons follow.

<table>
<thead>
<tr>
<th>Key Figure*</th>
<th>Pounds in Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average assets</td>
<td>£4,015.9</td>
</tr>
<tr>
<td>Net income</td>
<td>243.6</td>
</tr>
<tr>
<td>Revenues</td>
<td>6,458.0</td>
</tr>
<tr>
<td>Return on assets</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

* Figures prepared in accordance with generally accepted accounting principles in the United Kingdom.

Required

1. Identify any concerns you have in comparing Dixons’ net income and revenue figures to those of Best Buy and Circuit City (in BTN 1-2) for purposes of making business decisions.

2. Identify any concerns you have in comparing Dixons’ return on assets ratio to those of Best Buy and Circuit City (computed for BTN 1-2) for purposes of making business decisions.

ANSWERS TO MULTIPLE CHOICE QUIZ

1. c; $450,000 is the actual cost incurred.
2. b; revenue is recorded when earned.
3. d;

```
<table>
<thead>
<tr>
<th>Assets =</th>
<th>Liabilities +</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>+$100,000</td>
<td>+ 35,000</td>
<td>+ ?</td>
</tr>
</tbody>
</table>
```

Change in equity = $100,000 − $35,000 = $65,000

4. a
5. a