

Chapter 1

Accounting and the Business Environment

T Questions

1. Accounting is a system for measuring, processing, and communicating financial information. Bookkeeping is a procedure in accounting.
2.
 - a. Individuals use accounting information to manage bank accounts, among other things.
 - b. Managers use accounting information to set goals for their businesses and to determine what equipment to buy, for example.
 - c. Investors and creditors use accounting information to evaluate investments and loan applications.
 - d. Government agencies (including taxation authorities) use accounting data in regulating business activity.
 - e. Nonprofit organizations such as churches and hospitals use accounting information in much the same way that managers of businesses do—to run their organizations.
3. The Financial Accounting Standards Board (FASB) formulates generally accepted accounting principles. The FASB is a private organization, not a government agency, nor is it part of any other organization.

4. Ethical standards in accounting are designed to produce honest, accurate information for decision-making. The AICPA's ethical standards are directed more toward independent auditors. The IMA's standards relate more to management accountants.
5. The entity concept draws clear boundaries around each economic unit. It is important because it allows decision makers to evaluate each entity as a separate economic unit.
6. The reliability principle states that accounting information should be based on the most objective and verifiable data possible.
7. The cost principle dictates that assets and services be recorded at their actual cost and that cost remains their accounting value.
8. Liabilities = Assets ! Owner's Equity.
9. An account receivable is an asset because it is an economic resource that provides a future benefit—the right to collect cash from a customer. An account payable is a liability because it represents an economic obligation to pay a creditor.
10. A more descriptive title for the balance sheet is the “statement of financial position.” The balance between assets on the left side, and liabilities and owner's equity on the right side, gives this financial statement its name. The balance appears in the accounting equation, $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$, which is essentially a summary of the balance sheet in equation form.
11. Another title for the income statement is the “statement of earnings” or the “statement of operations.” The balance sheet is like a snapshot of the entity at a specific time. The income statement is like a moving picture of the entity's operations during a period of time.

12. The statement of owner's equity presents a summary of the changes that occurred in owner's equity during the period due to net income or net loss and from owner withdrawals.
13. One synonym for the owner's equity of a proprietorship is *capital*.
14. Net income (or net loss) flows from the income statement to the statement of owner's equity. Ending capital then flows to the balance sheet. The amount of cash on the balance sheet is explained by the statement of cash flows.

T Daily Exercises

(5-10 min.) **DE 1-1**

1. Record assets and liabilities at actual historical amounts (cost) (cost principle).
2. Keep your business's accounting records *separate* from your personal records so that you can evaluate the success or failure of the business. If your personal records get mixed up with your business's accounting records, it may become difficult to tell how well the business is performing (entity concept).

(5-10 min.) **DE 1-2**

Assets are the economic resources of a business that are expected to be of benefit in the future.

Liabilities are “outsider claims,” which are economic obligations—debts—payable to outsiders.

Owner's equity is the claim of “insiders” (the owners of the business) to the assets of the business.

The relationship among assets, liabilities, and owner's equity is given by the accounting equation:

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

(5 min.) **DE 1-3**

Revenues are increases in owner's equity that are earned by delivering goods or services to customers.

Expenses are decreases in owner's equity that occur from using assets or increasing liabilities in the course of delivering goods or services to customers.

Total revenues ! Total expenses = Net income or Net loss

(5 min.) **DE 1-4**

Assets	=	Liabilities	+	Owner's Equity
Cash		Note Payable		Owner, Capital
<hr/>				
\$2,000 + \$8,000	=	\$8,000	+	\$2,000
$\underbrace{\hspace{1.5cm}}$				
\$10,000				

(5-10 min.) **DE 1-5**

Assets	=	Liabilities	+	Owner's Equity		
Cash + Furniture	=	Accounts Payable	+	Note Payable	+	Trujillo, Capital
<hr/>						
\$5,000 + \$12,000	=	\$1,000	+	\$6,000	+	\$10,000

Based on the accounting equation, Trujillo has \$10,000 equity in the business.

(5 min.) **DE 1-6**

Gillen recorded no liability for the purchase of land because she paid for the land with cash when she bought it. She has no debt—no liability—to make a future payment for the land.

(10 min.) **DE 1-7**

Cash:	\$13,500 (\$10,000 + \$3,500)
Total assets:	\$34,000 (\$13,500 + \$500 + \$20,000)
Gay Gillen, capital:	\$33,500 (\$30,000 + \$3,500)

(5 min.) **DE 1-8**

In Transaction 9, Gillen received Cash and decreased the asset Accounts Receivable. There was no revenue to record for Transaction 9 because the business had already recorded the revenue when it was earned (in Transaction 5). To record the revenue as part of Transaction 9 would double count the revenue.

(5 min.) **DE 1-9**

Gay Gillen eTravel			
Balance Sheet			
April 2, 20X1			
ASSETS		OWNER'S EQUITY	
Cash	\$30,000	Gay Gillen, capital	\$30,000
	<u> </u>	Total liabilities and	<u> </u>
Total assets	<u>\$30,000</u>	owner's equity	<u>\$30,000</u>

(15-20 min.) **DE 1-10**

Gay Gillen eTravel		
Income Statement		
Three Weeks Ended April 21, 20X1		
Revenue:		
Service revenue		\$8,500
Expenses:		
Salary expense	\$1,200	
Rent expense, office	1,100	
Lease expense, computer	400	
Utilities expense	<u>400</u>	
Total expenses		<u>3,100</u>
Net income		<u>\$5,400</u>

Gay Gillen eTravel	
Statement of Owner's Equity	
Three Weeks Ended April 21, 20X1	
Gay Gillen, capital, April 1, 20X1	\$ 0
Add: Investments by owner	30,000
Net income for the period	<u>5,400</u>
	35,400
Less: Withdrawals by owner	<u>(0)</u>
Gay Gillen, capital, April 30, 20X1	<u>\$35,400</u>

Gay Gillen eTravel			
Balance Sheet			
April 21, 20X1			
ASSETS		LIABILITIES	
Cash	\$12,100	Accounts payable	\$ 200
Accounts receivable	3,000		
Office supplies	500	OWNER'S EQUITY	
Land	20,000	Gay Gillen, capital	35,400
	<u> </u>	Total liabilities and	<u> </u>
Total assets	<u>\$35,600</u>	owner's equity	<u>\$35,600</u>

(5 min.) **DE 1-11**

$$X \quad ! \quad Y \quad = \quad Z$$

Total revenues ! Total expenses = Net income or Net loss

(5 min.) **DE 1-12**

1. The *income statement* measures net income or net loss. Net income goes into the statement of owner's equity. Owner's equity is net income's final resting place.
2. The *balance sheet* lists the assets, liabilities, and owner's equity. Owner's equity is most directly affected by net income.

(5-10 min.) **DE 1-13**

1. Net income \$4,100 (\$8,500 ! \$2,500 ! \$1,100 ! \$400 ! \$400)
2. Gay Gillen, capital \$32,000 (\$30,000 + \$4,100 ! \$2,100)
3. Ending cash \$18,700 (\$20,000 ! \$2,500 + \$1,200)

(5-10 min.) **DE 1-14**

1. Operating activities
Investing activities
Financing activities
2. Collections from customers—*operating* activity because collections are related to the day-to-day operation of the business, which consists of providing service for clients and collecting cash.

Acquisition of land—*investing* activity because the business has invested money to buy the land, which is an asset.

Investment by owner—*financing* activity because the owner's investment financed the business to get it started.

3. The *statement of cash flows* shows how the ending cash balance is determined. The *balance sheet* also reports the cash balance at the end of the period.

Note: Student answers may vary.

(5-10 min.) **DE 1-15**

Montvale Delivery Service		
Income Statement		
Year Ended December 31, 20X3		
Revenue:		
Service revenue		\$101,000
Expenses:		
Salary expense	\$32,000	
Rent expense	8,000	
Fuel expense	6,000	
Insurance expense	4,000	
Supplies expense	<u>1,000</u>	
Total expenses		<u>51,000</u>
Net income		<u>\$50,000</u>

(5 min.) **DE 1-16**

Montvale Delivery Service	
Statement of Owner's Equity	
Year Ended December 31, 20X3	
Owner, capital, December 31, 20X2	\$13,000
Add: Net income for the year	<u>50,000</u>
	63,000
Less: Withdrawals by owner	<u>(36,000)</u>
Owner, capital, December 31, 20X3	<u>\$27,000</u>

(5-10 min.) **DE 1-17**

Montvale Delivery Service			
Balance Sheet			
December 31, 20X3			
ASSETS		LIABILITIES	
Cash	\$16,000	Accounts payable	\$ 8,000
Accounts receivable	17,000		
Supplies	2,000	OWNER'S EQUITY	
		Owner, capital	27,000
		Total liabilities and	
Total assets	<u>\$35,000</u>	owner's equity	<u>\$35,000</u>

(10 min.) **DE 1-18**

1. The business earned a *profit (net income)* of \$50,000. The owner will be pleased because net income exceeded the goal.
2. Owner's capital *increased* because net income exceeded withdrawals by the owner. This is a sign that the business is growing.
3. Total assets ! Total liabilities = Owner's equity
\$35,000 ! \$8,000 = \$27,000

Financial position looks *strong* because total assets are more than four times the amount of total liabilities.

T Exercises

(15-20 min.) **E 1-1**

The *balance sheet* reports the assets, liabilities, and owner's equity of the entity at a particular point in time. The *assets* show the resources the business has to work with. Because borrowers pay loans with assets, a lender wants to know the business's assets (especially cash). *Liabilities*—debts—represent creditors' claims to the business's assets. If the borrower already owes a lot of money, he may be unable to repay the loan. *Owner's equity* is the portion of the business assets owned outright by the owner. The higher the owner's equity, the stronger the borrower's financial position, and the greater the probability of loan repayment.

The *income statement* reports the revenues and expenses of a particular entity for a period such as a month or a year. Total *revenues* minus total *expenses* equals *net income*, or profit. A lender requires this information in order to predict whether the borrower can generate enough income to repay the loan.

Note: Student responses may vary.

(5-10 min.) **E 1-2**

- a. Purchase of asset on account
Borrow money
- b. Purchase of asset for cash
Sale of asset for cash
Collection of an account receivable
- c. Withdrawal by owner
Expense transaction
- d. Pay a liability
- e. Investment by owner
Revenue transaction

Note: Answers may vary.

(10-15 min.) **E 1-3**

- a. Increased assets (cash)
- b. No effect on total assets. Increase in land offset the decrease in cash.
- c. Decreased assets (cash)
- d. Increased assets (machinery and equipment)
- e. Increased assets (accounts receivable)
- f. Decreased assets (cash)
- g. No effect on total assets. Increase in cash offset the decrease in accounts receivable.
- h. No effect (a personal transaction)
- i. No effect on total assets. Increase in cash offset the decrease in land.
- j. Increased assets (cash)

(5-10 min.) **E 1-4**

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Company A	\$96,200		\$61,800		\$34,400
Company B	65,900		31,900		34,000
Company C	81,700		79,800		1,900

(10-15 min.) **E 1-5**

Amounts in Millions

	<u>Total Assets</u>	!	<u>Total Liabilities</u>	=	<u>Total Owners' equity</u>
Beginning. . .	\$5,819	!	\$2,861	=	\$2,958

Req. 1

Increase during the year. . . 737

Ending. . .	<u>\$7,260</u>	!	<u>\$3,565</u>	=	<u>\$3,695</u>
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Req. 2

Possible reasons for the increase in owners' equity:

1. Net income.
2. Investors made additional investments in the company.

We find the solution by preparing the statement of owner's equity, plugging in the known amounts, and determining the net income or net loss (X). For assumption 1:

$$\begin{aligned} \$41,000 + \$5,000 + X &= \$64,000 \\ X &= \$64,000 - \$41,000 - \$5,000 \\ X &= \$18,000 \end{aligned}$$

Telemarketing Associates			
Statement of Owner's Equity			
Month Ended June 30, 20X2			
	1	2	3
Capital, May 31, 20X2			
(\$150,000 ! \$109,000)	\$41,000	\$41,000	\$41,000
Add: Investments by owner	5,000	-0-	41,000
Net income for the month	<u>18,000</u>	<u>34,000</u>	<u>-0-</u>
	64,000	75,000	82,000
Less: Withdrawals by owner	(-0-)	(11,000)	(6,000)
Net loss for the month	<u>_____</u>	<u>_____</u>	<u>(12,000)</u>
Capital, June 30, 20X2			
(\$195,000 ! \$131,000)	<u>\$64,000</u>	<u>\$64,000</u>	<u>\$64,000</u>

$$2: \$41,000 + 0 + X - \$11,000 = \$64,000; X = \$34,000$$


$$3: \$41,000 + \$41,000 + X - \$6,000 = \$64,000; X = -\$12,000$$

- a. Increase asset (Cash)
Increase owner's equity (Capital)
- b. Increase asset (Office Supplies)
Decrease asset (Cash)
- c. Increase asset (Accounts Receivable)
Increase owner's equity (Service Revenue)
- d. Increase asset (Office Furniture)
Increase liability (Accounts Payable)
- e. Increase asset (Cash)
Decrease asset (Accounts Receivable)
- f. Decrease asset (Cash)
Decrease liability (Accounts Payable)
- g. Increase asset (Cash)
Decrease asset (Land)
- h. Increase asset (Cash)
Increase owner's equity (Service Revenue)
- i. Decrease asset (Cash)
Decrease owner's equity (Rent Expense)


(10-20 min.) **E 1-8**

Analysis of Transactions

DATE	ASSETS			=	LIABILITIES +		OWNER'S EQUITY	TYPE OF OWNER'S EQUITY TRANSACTION
	CASH +	MEDICAL SUPPLIES +	LAND	=	ACCOUNTS PAYABLE +	LANCE HUBER, CAPITAL		
May 6	<u>90,000</u>					<u>90,000</u>	Owner investment	
Bal.	90,000					90,000		
9	<u>(55,000)</u>		<u>55,000</u>					
Bal.	35,000		55,000			90,000		
12		<u>2,000</u>			<u>2,000</u>			
Bal.	35,000	2,000	55,000		2,000	90,000		
15	Not a transaction of the business							
15-31	<u>7,000</u>					<u>7,000</u>	Service revenue	
Bal.	42,000	2,000	55,000		2,000	97,000		
15-31	<u>(1,400)</u>					<u>(1,400)</u>	Salary expense	
	<u>(1,000)</u>					<u>(1,000)</u>	Rent expense	
	<u>(300)</u>					<u>(300)</u>	Utilities expense	
Bal.	39,300	2,000	55,000		2,000	94,300		
28	<u>500</u>	<u>(500)</u>						
Bal.	39,800	1,500	55,000		2,000	94,300		
31	<u>(1,500)</u>				<u>(1,500)</u>			
Bal.	<u>38,300</u>	<u>1,500</u>	<u>55,000</u>		<u>500</u>	<u>94,300</u>		



94,800



94,800

Req. 1

- a. Investment by owner
- b. Cash purchase of lease equipment
- c. Purchase of lease equipment on account payable
- d. Lease of equipment on account receivable
- e. Payment of cash expenses
- f. Lease of equipment for cash
- g. Payment of cash on account payable
- h. Collection of cash on account receivable

Req. 2

Revenues (\$6,600 + \$800)	\$7,400
Less: Expenses	<u>2,000</u>
Net income	<u>\$5,400</u>

Req. 1

TELETAX is a proprietorship, as shown by the account, “M. Dalton, Capital.”

Req. 2

TELETAX			
Balance Sheet			
September 30, 20X2			
ASSETS		LIABILITIES	
Cash	\$ 950	Accounts payable	\$ 1,750
Accounts receivable	6,900	Note payable	<u>8,000</u>
Supplies	600	Total liabilities	9,750
Office equipment	15,500	OWNER'S EQUITY	
	<u> </u>	M. Dalton, capital	<u>14,200*</u>
		Total liabilities and	
Total assets	<u>\$23,950</u>	owner's equity	<u>\$23,950</u>

$$\begin{array}{r}
 \text{* Total assets} \quad ! \quad \text{Total liabilities} \quad = \quad \text{Capital} \\
 \hline
 \$23,950 \quad ! \quad \$9,750 \quad = \quad \$14,200
 \end{array}$$

The balance sheet reports *financial position*.

The income statement reports *operating results*.

Req. 1

Venecor Import Service		
Income Statement		
Year Ended December 31, 20X3		
Revenue:		
Service revenue		\$161,200
Expenses:		
Salary expense	\$49,000	
Rent expense	24,000	
Utilities expense	6,800	
Supplies expense	4,000	
Property tax expense	<u>1,200</u>	
Total expenses		<u>85,000</u>
Net income		<u>\$ 76,200</u>

Results of operations for 20X3: Net income of \$76,200

Req. 2

First we prepare the statement of owner's equity for the year ended December 31, 20X3, as follows:

Venecor Import Service	
Statement of Owner's Equity	
Year Ended December 31, 20X3	
Capital, beginning of year	\$ -0-
Add: Investment by owner	15,000
Net income for the year (<i>Req. 1</i>)	<u>76,200</u>
	91,200
Less: Withdrawals by owner	<u>(64,100)</u>
Capital, end of year	<u>\$ 27,100</u>

To solve for proprietor's withdrawals, we put the data in equation form:

$$\$0 + \$15,000 + \$76,200 - \$X = \$27,100$$

$$X = \$76,200 + \$15,000 - \$27,100$$

$$X = \$64,100$$

	<i>(Millions)</i>	
	19X9	19X8
1. Revenues	\$11,170	
Expenses	<u>11,302</u>	
Net income (net loss)	<u>\$ (132)</u>	<u>\$ 490</u>

Net income decreased by \$622 million to a net loss of \$132 million.

		<i>(Millions)</i>			
2. Total assets		!	Total liabilities	=	Owners' equity
Year end					
19X8	\$7,963	!	\$3,535	=	\$4,428
(Decrease) during 19X9					(804)
19X9	\$7,899	!	\$4,275	=	\$3,624

Performance evaluation for 19X9: Poor, because 19X9 was a loss year. As a result, owners' equity decreased during 19X9.

Lands' End, Inc.		
Statement of Cash Flows (Adapted)		
For the Year 19X8		
	<i>Millions</i>	
Cash flows from operating activities:		
Receipts:		
Collections from customers		\$1,257
Payments:		
To suppliers and employees		<u>(1,284)</u>
Net cash (outflow) from operating activities		(27)
Cash flows from investing activities:		
Purchases of assets	<u>\$ (35)</u>	
Net cash (outflow) from investing activities		(35)
Cash flows from financing activities:		
Payments of dividends to owners	<u>\$ (10)</u>	
Net cash (outflow) from financing activities		<u>(10)</u>
Net increase (decrease) in cash		\$ (72)
Cash balance, beginning of year		<u>93</u>
Cash balance, end of year		<u>\$ 21</u>

CHALLENGE EXERCISE

(30-40 min.) **E 1-14**

Computed amounts are shown in boxes.

	<u>Circle Co.</u>	<u>Triangle Co.</u>	<u>Square Co.</u>
Beginning:			
Assets	\$105,000	\$ 50,000	\$ 110,000
! Liabilities	<u>(50,000)</u>	<u>(20,000)</u>	<u>(60,000)</u>
= Owner's equity	<u>\$ 55,000</u>	<u>\$ 30,000</u>	<u>\$ 50,000</u>
Ending:			
Assets	\$160,000	\$ 70,000	\$ 170,000 ⁴
! Liabilities	<u>(70,000)</u>	<u>(35,000)</u>	<u>(80,000)</u>
= Owner's equity	<u>\$ 90,000</u>	<u>\$ 35,000</u>	<u>\$ 90,000</u>
Owner's Equity:			
Investments by owner	\$ 25,000 ¹	\$ 0	\$ 10,000
! Withdrawals by owner	<u>(100,000)</u>	<u>(40,000)</u>	<u>(70,000)</u>
= Net increase (decrease)		<u>\$(40,000)</u>	
Income Statement:			
Revenues	430,000	230,000	\$400,000
! Expenses	<u>(320,000)</u>	<u>(185,000)</u> ³	<u>(300,000)</u>
= Net income	<u>\$110,000</u>	<u>\$ 45,000</u>	<u>\$100,000</u>
Statement of Owner's Equity:			
Beginning owner's equity	\$ 55,000	\$ 30,000	\$ 50,000
+ Investments by owner	X ¹	0	10,000
+ Net income	110,000	Y ²	100,000
! Withdrawals by owner	<u>(100,000)</u>	<u>(40,000)</u>	<u>(70,000)</u>
= Ending owner's equity	<u>\$ 90,000</u>	<u>\$ 35,000</u>	<u>\$ 90,000</u>

¹\$55,000 + Investments (X) +
\$110,000 ! \$100,000 = \$90,000
Investments = \$25,000

²Net income (Y) = \$45,000

³Revenues ! expenses
= net income
\$230,000 ! expenses
= \$45,000
Expenses = \$185,000

⁴Assets ! liabilities = OE
Assets ! \$80,000 = \$90,000
Assets = \$170,000