

LEARNING OBJECTIVES

Careful study of this chapter should enable you to:

- LO1 Define the accounting elements.
- LO2 Construct the accounting equation.
- LO3 Analyze business transactions.
- LO4 Show the effects of business transactions on the accounting equation.
- LO5 Prepare and describe the purposes of a simple income statement, statement of owner's equity, and balance sheet.
- LO6 Define the three basic phases of the accounting process.

t Rob's Bike Courier Service in Fort Collins, Colorado, Rob believes "less is more." His small company doesn't "have a fleet of vehicles, just some pretty cool bicycles." His mission is providing successful bike delivery service, perfect for both traditional business delivery services and residential errands. Since January of 2005, Rob's Bike Courier Service has been the alternative to gas-powered vehicle delivery. Thus, besides great rates and friendly, reliable service, Rob offers earth-friendly service.

Currently, he delivers wholesale bagels from a mid-town baker to several downtown coffee shops. He does the same for another pastry chef. Rob also picks up recycling materials, offers bike towing services, and will go to a customer's home to fix flat bike tires and make repairs.

Though his company is small, Rob still needs an accounting system to maintain records of his business transactions and to prepare financial statements. Currently, he uses Quickbooks®, an accounting program used by many small companies. In Chapters 2 through 6, we learn how to account for a service business like Rob's by using an example of a similar company: Mitchell's Campus Delivery.

The entire accounting process is based on one simple equation, called the accounting equation. In this chapter, you will learn how to use this equation to analyze business transactions. You will also learn how to prepare financial statements that report the effect of these transactions on the financial condition of a business.

LO1

The Accounting Elements

Define the accounting elements.

LEARNING KEY

help you analyze even the

most complex business

transactions.

Before the accounting process can begin, the entity to be accounted for must be defined. A business entity is an individual, association, or organization that engages in economic activities and controls specific economic resources. This definition allows the personal and business finances of an owner to be accounted for separately.

Three basic accounting elements exist for every business entity: assets, liabilities, and owner's equity. These elements are defined below.

Assets

Pay close attention
to the definitions for the
basic accounting elements.
A clear understanding
of these definitions will

Assets are items that are owned by a business and will provide future benefits. Examples of assets include cash, merchandise, furniture, fixtures, machinery, buildings, and land. Businesses may also have an asset called accounts receivable. This asset represents the amount of money owed to the business by its customers as a result of making sales "on account," or "on credit." Making sales on account simply means that the customers have promised to pay sometime in the future.

Liabilities

Liabilities represent something owed to another business entity. The amount owed represents a probable future outflow of assets as a result of a past event or transaction. Liabilities are debts or obligations of the business that can be paid with cash, goods, or services.

The most common liabilities are accounts payable and notes payable. An account payable is an unwritten promise to pay a supplier for assets purchased or services received. Acquiring assets or services by promising to make payments in the future is referred to as making a purchase "on account," or "on credit." Formal written promises to pay suppliers or lenders specified sums of money at definite future times are known as notes payable.

LEARNING KEY

Owner's Equity Owner's equity is the amount by which the business assets exceed the business liabili-

The business entity's assets and liabilities are separate from the owner's nonbusiness assets and liabilities.

no business liabilities, the owner's equity is equal to the total assets.

The owner of a business may have business assets and liabilities as well as non-business assets and liabilities. For example, the business owner probably owns a home, clothing, and a car, and perhaps owes the dentist for dental service. These are personal, nonbusiness assets and liabilities. According to the business entity concept, nonbusiness

ness assets and liabilities are not included in the business entity's accounting records.

ties. Other terms used for owner's equity include net worth and capital. If there are

If the owner invests money or other assets in the business, the item invested is reclassified from a nonbusiness asset to a business asset. If the owner withdraws money or other assets from the business for personal use, the item withdrawn is reclassified from a business asset to a nonbusiness asset. These distinctions are important and allow the owner to make decisions based on the financial condition and results of the business apart from nonbusiness activities.

CHECKPOINT V

Complete Checkpoint-1 on page 41 to test your basic understanding of LO1.



A BROADER VIEW

Assets and the Cost of Products We Buy

ext time you buy something, think of all the assets a company needs to produce that product. If the product comes from a capital-intensive industry, one that requires heavy investments in assets, the company must price the product high enough to cover the cost of using the assets and replacing them when they wear out. For example, AT&T recently reported that the cost of property, plant, and equipment used for operating purposes came to over \$319 billion.

LO₂

The Accounting Equation

Construct the accounting equation.

The relationship between the three basic accounting elements—assets, liabilities, and owner's equity—can be expressed in the form of a simple equation known as the accounting equation.

Assets = Liabilities + Owner's Equity

This equation reflects the fact that both outsiders and insiders have an interest in the assets of a business.

- Liabilities represent the outside interests of creditors.
- Owner's equity represents the inside interests of owners.

Or, viewed another way,

The left side of the equation shows the assets.

The right side of the equation shows where the money came from to buy the assets.

When two elements are known, the third can always be calculated. For example, assume that assets on December 31 total \$60,400. On that same day, the business liabilities consist of \$5,400 owed for equipment. Owner's equity is calculated by subtracting total liabilities from total assets, \$60,400 - \$5,400 = \$55,000.

Assets	=	Liabilities	+	Owner's Equity
\$60,400	=	\$5,400	+	\$55,000
\$60,400	=		\$60,400	

If during the next accounting period, assets increased by \$10,000 and liabilities increased by \$3,000, owner's equity must have increased by \$7,000 (\$10,000 – \$3,000) as shown on the next page.



If you know two accounting elements, you can calculate the third element.

Total assets \$60,400Total liabilities -5,400

Total liabilities $\frac{-5,400}{55,000}$ Owner's equity

tada ka	Assets	TRUTT THE S	Liabilities	A +	Owner's Equity
ВВ	\$60,400		\$5,400		\$55,000
	+10,000	=	+3,000	+	+7,000
EB	\$70,400	=	\$8,400	+	\$62,000
	\$70,400	= =		\$70,400	

CHECKPOINT

Complete Checkpoint-2 on page 41 to test your basic understanding of LO2.

BB: Beginning balance

EB: Ending balance

Note also that after computing the ending balances for assets, liabilities, and owner's equity, the accounting equation remains in balance.

LO₃

Analyzing Business Transactions

Analyze business transactions.

A business transaction is an economic event that has a direct impact on the business. A business transaction almost always requires an exchange between the business and another outside entity. We must be able to measure this exchange in dollars. Examples of business transactions include buying goods and services, selling goods and services, buying and selling assets, making loans, and borrowing money.

All business transactions affect the accounting equation through specific accounts. An account is a separate record used to summarize changes in each asset, liability, and the owner's equity of a business. Account titles provide a description of the particular type of asset, liability, or owner's equity affected by a transaction.

Three basic questions must be answered when analyzing the effects of a business transaction on the accounting equation. These questions help address the steps in the accounting process discussed in Chapter 1.

- 1. What happened?
 - Make certain you understand the event that has taken place.
- 2. Which accounts are affected?
 - Identify the accounts that are affected.
 - Classify these accounts as assets, liabilities, or owner's equity.
- 3. How is the accounting equation affected?
 - Determine which accounts have increased or decreased.
 - Make certain that the accounting equation remains in balance after the transaction has been entered.

LO4

Effect of Transactions on the Accounting Equation

Show the effects of business transactions on the accounting equation.

In Chapters 2 through 6, we will focus on learning how to account for a business similar to Rob's Bike Courier Service, discussed in the chapter opener. In these chapters, we will focus on Mitchell's Campus Delivery. By studying Mitchell's business transactions and accounting techniques, you will learn about business and accounting. A major advantage of studying accounting is that it helps you learn a great deal about business.

As explained earlier, we must first understand the economic substance of events. Then, we must determine how that information is entered into the accounting system. If Mitch does not understand the economic events affecting his delivery business and their impact on the accounting equation, the events will not be correctly entered into the accounting system.

Each transaction affects at least two accounts and one or more of the three basic accounting elements. A transaction increases or decreases specific asset, liability, or owner's equity accounts. Assume that the following transactions occurred during June 20--, the first month of operations for Mitchell's Campus Delivery.

Remember, capital does not mean cash. The cash is shown in the cash account.

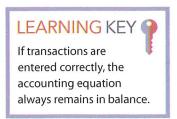
Transaction (a): Investment by owner

An Increase in an Asset Offset by an Increase in Owner's Equity. Mitch Williams opened a bank account with a deposit of \$5,000 for his business. The new business now has \$5,000 of the asset Cash. Since Mitch contributed the asset, the owner's equity element, Mitchell Williams, Capital, increases by the same amount.

Assets (Items Owned)	=	Liabilities (Amounts Owed)	+	Owner's Equity (Owner's Investment)
Cash	=			Mitchell Williams, Capital
(a) \$5,000	=			\$5,000

Transaction (b): Purchase of an asset for cash

An Increase in an Asset Offset by a Decrease in Another Asset. Mitch decided that the fastest and easiest way to get around campus and find parking is on a motor scooter. Thus, he bought a motor scooter (delivery equipment) for \$2,000 cash. Mitch exchanged one asset, cash, for another, delivery equipment. This transaction reduces Cash and creates a new asset, Delivery Equipment.



	Asset (Items Ow	The state of the s	=	Liabilities + (Amounts Owed)	Owner's Equity (Owner's Investment)
	Cash +	Delivery Equipment	= 1		Mitch Williams, Capital
	\$5,000	production of			\$5,000
(b)	-2,000	+\$2,000			-
	\$3,000 +	\$2,000	=		\$5,000
	\$5,000)	=		\$5,000

Transaction (c): Purchase of an asset on account

An Increase in an Asset Offset by an Increase in a Liability. Mitch hired a friend to work for him, which meant that a second scooter would be needed. Given Mitch's limited cash, he bought a secondhand model for \$1,800. The seller agreed to allow Mitch to spread the payments over the next three months. This transaction increased an asset, Delivery Equipment, by \$1,800 and increased the liability, Accounts Payable, by an equal amount.

a oti ense	Assets (Items Own	The second secon	eA_zs tor ca	Liabilities (Amounts Owed)	une 4	Owner's Equity (Owner's Investment)
12 (14)	Cash +	Delivery Equipment	ga) fas G) Tool	Accounts Payable	() () †	Mitchell Williams, Capital
	\$3,000	\$2,000		zeroni lune	20,20,20	\$5,000
(c)		+1,800		+\$1,800		
	\$3,000 +	\$3,800	=	\$1,800	+	\$5,000
	\$6,800		=	(6,80	00

Transaction (d): Payment on a loan

A Decrease in an Asset Offset by a Decrease in a Liability. Mitch paid the first installment on the scooter of \$600 [see transaction (c)]. This payment decreased the asset, Cash, and the liability, Accounts Payable, by \$600.

		sset s Ow		= 231	Liabilities (Amounts Owed)	+	Owner's Equity (Owner's Investment)
	Cash	+	Delivery Equipment	0'≅(0)	Accounts Payable	+	Mitchell Williams, Capital
	\$3,000		\$3,800		\$1,800	excent of	\$5,000
(d)	-600				-600		
	\$2,400 + \$3,800				\$1,200	+	\$5,000
an market of	\$	6,200)	=	9	66,20	00

Expanding the Accounting Equation: Revenues, Expenses, and Withdrawals

In the preceding sections, three key accounting elements of every business entity were defined and explained: assets, liabilities, and owner's equity. To complete the explanation of the accounting process, three additional elements must be added to the discussion: revenues, expenses, and withdrawals.

More precisely, revenue is recognized when a "performance obligation" is satisfied. We will address the details of revenue recognition later in the text.

Revenues

Revenues represent the amount a business charges customers for products sold or services performed. Customers generally pay with cash or a credit card, or they promise to pay at a later date. Most businesses recognize revenues when earned, even if cash has not yet been received. Separate accounts are used to recognize different types of revenue. Examples include Delivery Fees; Consulting Fees; Rent Revenue, if the business rents space to others; Interest Revenue, for interest earned on bank deposits; and Sales, for sales of merchandise. Revenues increase both assets and owner's equity.

Expenses

Expenses represent the *decrease* in assets (or *increase* in liabilities) as a result of a company's efforts to produce revenues. Common examples of expenses are rent, salaries, supplies

LEARNING KEY

remember that expenses do not always reduce cash

increase cash right away.

and revenues do not always

It is important to

consumed, and taxes. As with revenues, separate accounts are used to keep the accounting records for each different type of expense. Expenses are "incurred" as

- assets are consumed (such as supplies), or
- services are provided (by employees, for example) to the business.

The two main purposes of recognizing an expense are (a) to keep track of the amount and types of expenses incurred and (b) to show the reduction in owner's equity. Again, an expense can cause a reduction in assets or an increase in liabilities. Wages earned by employees is a good example.

- If paid, the expense reduces owner's equity and an asset, Cash.
- If not paid, the expense reduces owner's equity and increases a liability, Wages Payable.

Either way, owner's equity is reduced. If total revenues are greater than total expenses for the period, the excess is the net income, or net profit, for the period. On the other hand, if total expenses are greater than total revenues for the period, the excess is a net loss for the period.

Revenues	\$9,000	Revenues	\$ 3,000
Expenses	5,000	Expenses	5,000
Net income	\$4,000	Net loss	\$(2,000)

The owner can determine the time period used in the measurement of net income or net loss. It may be a month, a quarter (three months), a year, or some other time period. The concept that income determination can be made on a periodic basis is known as the accounting period concept. Any accounting period of 12 months is called a fiscal year. The fiscal year frequently coincides with the calendar year.



Withdrawals

Withdrawals, or drawing, reduce owner's equity as a result of the owner taking cash or other assets out of the business for personal use. Since earnings are expected to offset withdrawals, this reduction is viewed as temporary.

The accounting equation is expanded to include revenues, expenses, and with-drawals. Note that revenues increase owner's equity, while expenses and drawing reduce owner's equity.

		sets Owned)	=	Liabilities (Amounts Owed)	+	Owner's Investment)	r's E	Equity (Earnings)
erită ari	Cash	3 (+)	Delivery Equipment	1 7/=75	Accounts Payable	+	Mitchell Williams, _ Mitchell Williams, Capital Drawing	+	Revenues – Expenses
Balance	\$2,400	+	\$3,800	=	\$1,200	+	\$5,000		
		\$6,200		=			\$6,200		

Effect of Revenue, Expense, and Withdrawal Transactions on the Accounting Equation

To show the effects of revenue, expense, and withdrawal transactions, the example of Mitchell's Campus Delivery will be continued. Assume that the following transactions took place in Mitchell's business during June 20--.

Transaction (e): Delivery revenues earned in cash

An Increase in an Asset Offset by an Increase in Owner's Equity Resulting from Revenue. Mitch received \$2,100 cash from clients for delivery services. This transaction increased the asset, Cash, and increased owner's equity by \$2,100. The increase in owner's equity is shown by increasing the revenue account, Delivery Fees, by \$2,100.

T. 6. A ZMUM		ssets s Ow		uino Viost	Liabilities (Amounts Owed)	+	(Owner's Ir	Owner nvestment)	's E	iquity (Earni	ings)	
17	Cash	+	Delivery Equipment	inselli) Lis a ju	Accounts Payable	+	Mitchell Williams, Capital	Mitchell Williams, Drawing	+	Revenues -	- Expenses	Description
	\$2,400		\$3,800		\$1,200		\$5,000					
(e)	+2,100 \$4,500	+	\$3,800	=		+	\$5,000		+	+\$2,100 \$2,100		Deliv. Fees
	\$	8,300		=				\$8,300				

Transaction (f): Paid rent for month

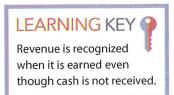
A Decrease in an Asset Offset by a Decrease in Owner's Equity Resulting from an Expense. Mitch rents a small office near campus. He paid \$1,000 for office rent for June. This transaction decreased both Cash and owner's equity by \$1,000. The decrease in owner's equity is shown by increasing an expense called Rent Expense by \$1,000. An increase in an expense decreases owner's equity.

25()±		ssets s Owi		L=.cr	Liabilities (Amounts Owed)	+	(Owner's	Owner nvestment)	r's +		ırnin	gs)	
india Lucia	Cash	1 (B) + 1 (3)	Delivery Equipment	32(1) = (1) (2)	Accounts Payable	+	Mitchell Williams, _ Capital	Mitchell Williams, Drawing	+	Revenues	-	Expenses	Description
	\$4,500	+	\$3,800		\$1,200		\$5,000			\$2,100			
(f)	-1,000 \$3,500	+	\$3,800	=	\$1,200	+	\$5,000		+	\$2,100	_	+ \$1,000 \$1,000	Rent Exp.
	(7,300)	=	L			\$7,300					

Transaction (g): Paid phone bill

A Decrease in an Asset Offset by a Decrease in Owner's Equity Resulting from an Expense. Mitch paid \$100 in cash for phone service. This transaction, like the previous one, decreased both Cash and owner's equity. This decrease in owner's equity is shown by increasing an expense called Phone Expense by \$100.

Ass (Items 0		nō i	Liabilities (Amounts Owed)	+	(Owner's I	Owner nvestment)	r's	Equity (Earnin	gs)	
Cash	Delivery + Equipment	i e	Accounts Payable	+	Mitchell Williams, _	Mitchell Williams, Drawing	+	Revenues -	Expenses	Description
\$3,500	\$3,800		\$1,200		\$5,000			\$2,100	\$1,000	
(g) -100 \$3,400	+ \$3,800	=	\$ 1,200	+	\$5,000		+	\$2,100 -	+100	Phone Expense
\$7,2	200	=	L			\$7,200			White the state of	



Transaction (h): Delivery revenues earned on account

An Increase in an Asset Offset by an Increase in Owner's Equity Resulting from Revenue. Mitch extends credit to regular customers. Often, delivery services are performed for which payment will be received later. Since revenues are recognized when earned, an increase in owner's equity must be reported by increasing the revenue account. Since no cash is received at this time, Cash cannot be increased. Instead, an increase is reported for another asset, Accounts Receivable. The total of Accounts Receivable at any point in time reflects the amount owed to Mitch by his customers. Deliveries made on account amounted to \$2,400. Accounts Receivable and Delivery Fees are increased.

Self.	Assets		=	Liabilities	+		Owne			raingo)	
	(Items Owned)			(Amounts Owed)		(Owner's Investn	ment)	+	(Ea	rnings)	
Cash +	Accounts Receivable	Delivery + Equipment	=	Accounts Payable	+	Williams, - Wi	litchell illiams, rawing	+	Revenues	- Expenses	Description
\$3,400		\$3,800		\$1,200		\$5,000			\$2,100	\$1,100	
(h)	+\$2,400					*			+2,400		Deliv. Fees
\$3,400 +	\$2,400	+ \$3,800	=	\$1,200	+	\$5,000		+	\$4,500	- \$1,100	
	\$9,600		=				\$9,6	00			

Transaction (i): Purchase of supplies

An Increase in an Asset Offset by a Decrease in an Asset. Mitch bought pens, paper, delivery envelopes, and other supplies for \$80 cash. These supplies should last for several months. Since they will generate future benefits, the supplies should be recorded as an asset. The accounting equation will show an increase in an asset, Supplies, and a decrease in Cash.

				sset s Ow	:s vned)		=	Liabilities - (Amounts Owed)		Owner's Investment)			rnings)	
	Cash	+	Accounts Receivable	+	Supplies	+ Delivery + Equipment	100 (100 =	Accounts Payable	Mitchell + Williams Capital	,- Williams,		Revenues	- Expenses	Description
	\$3,400		\$2,400			\$3,800		\$1,200	\$5,000)		\$4,500	\$1,100	
(i)	-80 \$3,320	+	\$2,400	+	+ \$80 \$80	+ \$3,800	=	\$ 1,200 -	+ \$5,000	-)	+	\$4,500	- \$1,100	
			9	9,60	0		_ =	1		\$9,600				

As shown in transactions (i) and (j), transactions do not always affect both sides of the accounting equation.

Transaction (j): Cash receipts from prior sales on account

An Increase in an Asset Offset by a Decrease in an Asset. Mitch received \$1,900 in cash for delivery services performed for customers earlier in the month [see transaction (h)]. Receipt of this cash increases the cash account and reduces the amount due from customers reported in the accounts receivable account. Notice that owner's equity is not affected in this transaction. Owner's equity increased in transaction (h) when revenue was recognized as it was earned, rather than now when cash is received.

ga sassili	21113		ssets os Own		1 38	<mark>vages</mark> a Drova	y Z		+	Owner (Owner's Investment)			ngs)	
Cash	+	Accounts Receivable		Supplies	#073 9 + 1	Delivery Equipment	(14) ; =	Accounts Payable	+	Mitchell Mitchell Williams, - Williams Capital Drawing	+	Revenues -	Expenses	Description
\$3,320		\$2,400		\$80		\$3,800		\$1,200		\$5,000		\$4,500	\$1,100	
(j) +1,900 \$5,220	+	-1,900 \$ 500	+	\$80	+	\$3,800	=	\$1,200	+	\$5,000	+	\$4,500 -	\$1,100	
	Can Associate Challe (Marchine)	9	\$9,600				=			\$9	,600)		

Transaction (k): Purchase of an asset on account making a partial payment

An Increase in an Asset Offset by a Decrease in an Asset and an Increase in a Liability. With business increasing, Mitch hired a second employee and bought a third motor scooter. The scooter cost \$1,000. Mitch paid \$300 in cash and will spread the remaining payments over the next four months. The asset Delivery Equipment increases by \$1,000, Cash decreases by \$300, and the liability Accounts Payable increases by \$700. Note that this transaction changes three accounts. Even so, the accounting equation remains in balance.

caescaus tait, ciu	9606 (8.50		Assets ns Owned)	BUVE MVOD	e assets an		Liabilities (Amounts Owed)	+	Owne (Owner's Investment		Equity + (Earni	ngs)	
Cash	+ 4	Accounts Receivable	+ Supplie	9S +	Delivery Equipment	=	Accounts Payable	+	Mitchell Mitchel Williams, - Williams Capital Drawing	3, -	+ Revenues -	Expenses	Description
\$5,220		\$500	\$80		\$3,800		\$1,200		\$5,000		\$4,500	\$1,100	
(k) -300					+1,000		+700						
\$4,920	+	\$500	+ \$80	+	\$4,800	=	\$1,900	+	\$5,000	-	+ \$4,500 -	\$1,100	
			\$10,300			=			\$10	0,3	00		-

LEARNING KEY

Both supplies and insurance are recorded as assets because they will provide benefits for several months.

Transaction (I): Payment of insurance premium

An Increase in an Asset Offset by a Decrease in an Asset. Since Mitch plans to graduate and sell the business next January, he paid \$700 for a seven-month liability insurance policy. Insurance is paid in advance and will provide future benefits. Thus, it is treated as an asset. We must expand the equation to include another asset, Prepaid Insurance, and show that Cash has been reduced.

vals and	vinda Çing	irawal. Wil 1) owner's c	Assets Items Owned)	siness, the	delivery has avestments			+	Owner's Investme			Equity (Earnin	ngs)	drawals a
	Cash	+ Accounts Receivable	+ Supplies +	Prepaid Insurance	+ Delivery Equipment	=	Accounts Payable	+	Mitchell Mitch Williams, - William Capital Draw	ams,	+	Revenues -	Expenses	Description
9	\$4,920	\$500	\$80		\$4,800		\$1,900		\$5,000			\$4,500	\$1,100	
(1)	-700			\$700	m t Ba									
9	\$4,220	+ \$500	+ \$80 +	\$700	+ \$4,800	=	\$1,900	+	\$5,000		+	\$4,500 -	\$1,100	
Name and Advances			\$10,300			=			\$1	10,300)			

Transaction (m): Payment of wages

A Decrease in an Asset Offset by a Decrease in Owner's Equity Resulting from an Expense. Mitch paid his part-time employees \$1,650 in wages. This represents an additional business expense. As with other expenses, Cash is reduced and owner's equity is reduced by increasing an expense.

	(l	Assets tems Owned)			=	Liabilities (Amounts Owed)	+	Owner (Owner's Investment)			ings)	
Cash	Accounts + Receivable	+ Supplies +	Prepaid Insurance	Delivery Equipment	=	Accounts Payable	+	Mitchell Mitchell Williams, - Williams, Capital Drawing	+	Revenues -	Expenses	Description
\$4,220	\$500	\$80	\$700	\$4,800		\$1,900		\$5,000		\$4,500	\$1,100	
(m) -1,650											+1,650	Wages Exp.
\$2,570	+ \$500	+ \$80 +	- \$700 -	÷ \$4,800	=	\$1,900	+	\$5,000	+	\$4,500 -	\$2,750	
		\$8,650			=			\$8,	650)		

Transaction (n): Deliveries made for cash and on account

An Increase in Two Assets Offset by an Increase in Owner's Equity. Total delivery fees for the remainder of the month amounted to \$3,500: \$900 in cash and \$2,600 on account. Since all of these delivery fees have been earned, the revenue account increases by \$3,500. Also, Cash increases by \$900 and Accounts Receivable increases by \$2,600. Thus, revenues increase assets and owner's equity. Note, once again, that recording these revenues impacts three accounts while the equation remains in balance.

			(Assets ns Owne	d)				=	Liabilities (Amounts Owed)	+ ((Owner's In	Owner ovestment)			rnings)	
	Cash +		Accounts eceivable	+	Supplies	+	Prepaid Insurance	+	Delivery Equipment	=	Accounts Payable	+	Mitchell Williams, Capital	Mitchell - Williams, Drawing	+	Revenues	- Expenses	Description
	\$2,570		\$ 500		\$80		\$700		\$4,800		\$1,900		\$5,000			\$4,500	\$2,750	
(n)	+900		+2,600													+3,500		Deliv. Fees
	\$3,470	+	\$3,100	+	\$80	+	\$700	+	\$4,800	=	\$1,900	+	\$5,000		+	\$8,000	- \$2,750	
				5	12,150					=				\$12	,15	0		

LEARNING KEY

Withdrawals by the owner are reported in the drawing account. Withdrawals are the opposite of investments by the owner.

Transaction (o): Withdrawal of cash from business

A Decrease in an Asset Offset by a Decrease in Owner's Equity Resulting from a Withdrawal by the Owner. At the end of the month, Mitch took \$3,000 in cash from the business to pay for textbooks, extra class fees, and living expenses. Since these expenditures are not related to his delivery business, this is a withdrawal. Withdrawals can be viewed as the opposite of investments by the owner. Both owner's equity and Cash decrease.

				A	Assets					=		+					quity			
				(Iten	ns Owne	d)			DEFRE -	(Amounts Owed)		(Owner's Inv	vestr	nent)	+	(Ear	nin	igs)	
	Cash	+	Accounts Receivable		Supplies	+	Prepaid Insurance		Delivery Equipment	=	Accounts Payable	+	Mitchell Williams, - Capital	Will	chell iams, awing	+	Revenues	-	Expenses	Description
	\$3,470	0	\$3,100		\$80		\$700		\$4,800		\$1,900		\$5,000				\$8,000		\$2,750	
(o)	-3,000	0												+\$3	3,000					
	\$ 470	- + C	\$3,100	+	\$80	+	\$700	+	\$4,800	=	\$1,900	+	\$5,000 -	\$3	3,000	+	\$8,000	-	\$2,750	
					\$9,150					=					\$9,	150				

FIGURE 2-1 Summary of Transactions Illustrated

		Asset (Items Ow			= Liabilities (Amounts Owe				rnings)	
Cash	+ Accounts Receivable	+ Supplies	Prepaid Insurance	+ Delivery Equipment	= Accounts Payable	Mitchell + Williams, Capital	Mitchell Williams, Drawing	+ Revenues	- Expenses	Description
5,000						5,000				
5,000 (2,000)				2,000		5,000				
3,000				2,000 1,800	1,800	5,000				
3,000 (600)				3,800	1,800 (600)	5,000				
2,400 2,100				3,800	1,200	5,000		2,100		Deliv. Fees
4,500 (1,000)	•		***************************************	3,800	1,200	5,000		2,100	1,000	Rent Exp.
3,500 (100)				3,800	1,200	5,000		2,100	1,000	Phone Exp
3,400	2,400			3,800	1,200	5,000		2,100 2,400	1,100	Deliv. Fees
3,400 (80)	2,400	80		3,800	1,200	5,000		4,500	1,100	
3,320 1,900	2,400 (1,900)	80		3,800	1,200	5,000		4,500	1,100	
5,220 (300)	500	80		3,800 1,000	1,200 700	5,000		4,500	1,100	
4,920 (700)	500	80	700	4,800	1,900	5,000		4,500	1,100	
4,220 (1,650)	500	80	700	4,800	1,900	5,000		4,500	1,100 1,650	Wages Exp
2,570 900	500 2,600	80	700	4,800	1,900	5,000		4,500 3,500	2,750	Deliv. Fees
3,470 (3,000)	3,100	80	700	4,800	1,900	5,000	3,000	8,000	2,750	
SERVICE STATES	+ 3,100	+ 80	+ 700	+ 4,800	= 1,900	+ 5,000	3,000	+ 8,000	- 2,750	
	Supplies Prepaid Delivery	s Insurance Equipment	P	\$ 470 3,100 80 700 4,800 \$9,150	Mitchell Williar Mitchell Williar Delivery Fees Rent Expense Phone Expens Wages Expens	ns, Capital ns, Drawing ee se	Equity	\$1,900 5,000 (3,000) 8,000 (1,000) (100) (1,650) \$9,150		ounts in () subtracted
	5,000 5,000 (2,000) 3,000 2,400 2,100 4,500 (1,000) 3,500 (100) 3,400 (80) 3,320 1,900 5,220 (300) 4,920 (700) 4,220 (1,650) 2,570 900 3,470 (3,000)	5,000 5,000 (2,000) 3,000 (800) 2,400 2,100 4,500 (1,000) 3,400 2,400 3,400 2,400 3,400 2,400 3,400 2,400 3,400 (80) 3,320 2,400 1,900 (1,900) 5,220 (300) 4,920 500 (700) 4,220 500 (1,650) 2,570 900 2,600 3,470 3,100 (3,000) 470 + 3,100 Cash Account Supplies Prepaid Delivery	Cash	Cash	Cash	Cash	Cash	Cash	Cash	Cash

As with the running totals in the table, the listing immediately below the table provides proof that the accounting equation is in balance.

CHECKPOINT Complete Checkpoint-3 on page 41 to test your basic

understanding of LO3/4.

Figure 2-1 shows a summary of the transactions. Use this summary to test your understanding of transaction analysis by describing the economic event represented by each transaction. At the bottom of Figure 2-1, the asset accounts and their totals are compared with the liability and owner's equity accounts and their totals.

LO₅

sheet.

Prepare and describe the purposes of a simple income statement, statement of owner's equity, and balance

Financial Statements

The name of the compared.
 The title of the statemer

Three financial statements commonly prepared by a business entity are the income statement, statement of owner's equity, and balance sheet. The transaction information gathered and summarized in the accounting equation may be used to prepare these financial statements. Figure 2-2 shows the following:

- 1. A summary of the specific revenue and expense transactions and the ending totals for the asset, liability, capital, and drawing accounts from the accounting equation
- 2. The financial statements and their linkages with the accounting equation and each other

Note that each of the financial statements in Figure 2-2 has a heading consisting of the following:

HEADING FOR FINANCIAL STATEMENTS

ny	Mitchell's Campus Delivery
nt	Income Statement, Statement of Owner's Equity,
	or Palance Cheet

3. The time period covered or the date of the statement For Month Ended June 30, 20--, or June 30, 20--

The income statement and statement of owner's equity provide information concerning events covering a period of time, in this case, *the month ended* June 30, 20--. The balance sheet, on the other hand, offers a picture of the business on *a specific date*, June 30, 20--.

GUIDELINES FOR PREPARING FINANCIAL STATEMENTS

- 1. Financial statements are prepared primarily for users not associated with the company. To make a good impression and enhance understanding, financial statements must follow a standard form with careful attention to placement, spacing, and indentations.
- 2. All statements have a heading with the name of the company, name of the statement, and accounting period or date.
- 3. Single rules (underlines) indicate that the numbers above the line have been added or subtracted.

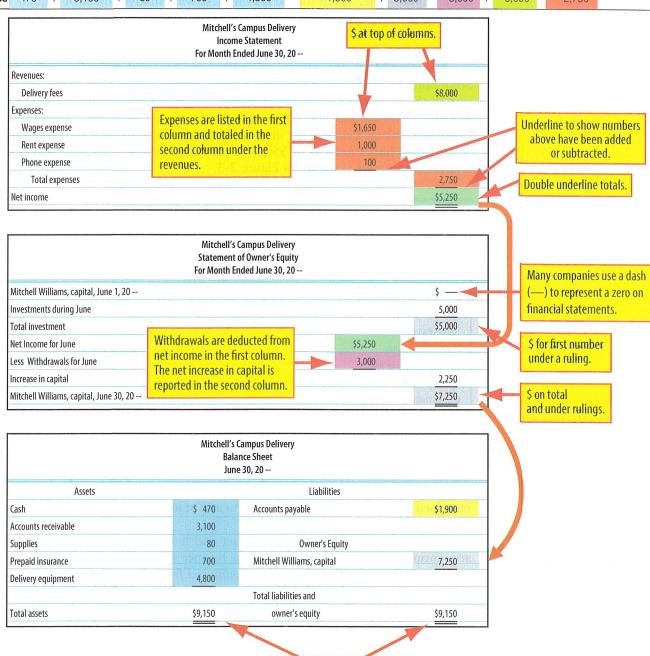
 Double rules (double underlines) indicate a total.
- 4. Dollar signs are used at the top of columns and for the first amount entered in a column beneath a ruling.
- On the income statement, some companies list expenses from highest to lowest dollar amount, with miscellaneous expense listed last.
- 6. On the balance sheet, assets are listed from most liquid to least liquid. **Liquidity** measures the ease with which the asset will be converted to cash. Liabilities are listed from most current to least current.

The Income Statement

The income statement, sometimes called the profit and loss statement or operating statement, reports the profitability of business operations for a specific period of time. Mitchell's income statement shows the revenues earned for the month of June.

FIGURE 2-2 Summary and Financial Statements

zoumov Jasek	2 (20)	E9.	(1)	ilV.	(1		Assens Ov	100000	d)	,1030	191	EL SHOL		Liabilities Amounts Owed)		(Owner's In				Equity (Earnin		
Trans- action	Cash	<u>.</u>		ccounts		+ S	uppli	ies -		Prepaid surance		Delivery Equipment	1	Accounts Payable	+	Mitchell Williams, - Capital	W	fitchell filliams, rawing	+	Revenues -	Expenses	Description
(e)									and the same of th											2,100		Deliv. Fees
(f)																					1,000	Rent Exp.
(g)																					100	Phone Exp.
(h)																				2,400		Deliv. Fees
(m)																					1,650	Wages Exp.
(n)																				3,500		Deliv. Fees
Balance	470	+		3,100	-	東地域位	80	+	- 100	700	+	4,800	=	1,900	+	5,000 -		3,000	+	8,000 -	2,750	



Double underline totals.

LEARNING I	
Revenues	\$ 500
Expenses	400
Net income	\$ 100
Income Stater	ment
Revenues	\$ 500
Expenses	_700
Net loss	\$(200)

Next, the expenses incurred as a result of the efforts made to earn these revenues are deducted. If the revenues are greater than the expenses, net income is reported. If the expenses are greater than the revenue, a net loss is reported.

By carefully studying the income statement, it is clear that Mitch earns revenues in only one way: by making deliveries. If other types of services were offered, these revenues would also be identified on the statement. Further, the reader can see the kinds of expenses that were incurred. The reader can make a judgment as to whether these seem reasonable given the amount of revenue earned. Finally, the most important number on the statement is the net income. This is known as the "bottom line."

The Statement of Owner's Equity

The statement of owner's equity illustrated in Figure 2-2 reports on these activities for the month of June. Mitch started his business with an investment of \$5,000. During the month of June, he earned \$5,250 in net income and withdrew \$3,000 for personal expenses. Mitch's \$5,000 original investment, plus the net increase of \$2,250, results in his ending capital of \$7,250.

Note that Mitchell's original investment and later withdrawal are taken from the accounting equation. The net income figure could have been computed from information in the accounting equation. However, it is easier to simply transfer net income as reported on the income statement to the statement of owner's equity. This is an important linkage between the income statement and statement of owner's equity.

If Mitch had a net loss of \$500 for the month, the statement of owner's equity would be prepared as shown in Figure 2-3.

FIGURE 2-3 Statement of Owner's Equity with Net Loss

Statement of	mpus Delivery Owner's Equity ed June 30, 20	
Mitchell Williams, capital, June 1, 20		\$ —
Investments during June		5,000
Total investment		\$5,000
Less: Net loss for June	\$500	
Withdrawals for June	3,000	
Decrease in capital		(3,500)
Mitchell Williams, capital, June 30, 20		\$1,500

Most firms also prepare a statement of cash flows. Given the complexity of this statement, we will postpone its discussion until later in this text.

CHECKPOINT W

Complete Checkpoint-4 on page 41 to test your basic understanding of LO5.

The Balance Sheet

The balance sheet reports a firm's assets, liabilities, and owner's equity on a specific date. It is called a balance sheet because it confirms that the accounting equation has remained in balance. It is also referred to as a statement of financial position or statement of financial condition.

As illustrated in Figure 2-2, the asset and liability accounts are taken from the accounting equation and reported on the balance sheet. The total of Mitchell's capital account on June 30 could have been computed from the owner's equity accounts in the accounting equation (\$5,000 - \$3,000 + \$8,000 - \$2,750 = \$7,250). However, it is simpler to take the June 30, 20--, capital as computed on the statement of owner's equity and transfer it to the balance sheet. This is an important linkage between these two statements.

Self-Study

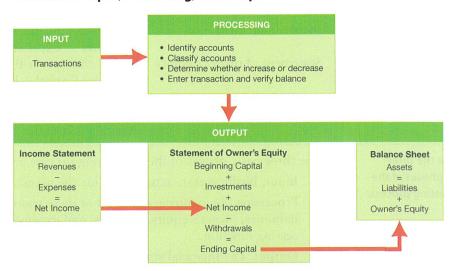
Overview of the Accounting Process

Define the three basic phases of the accounting process.

Figure 2-4 shows the three basic phases of the accounting process in terms of input, processing, and output.

- Input. Business transactions provide the necessary *input*.
- Processing. Recognizing the effect of these transactions on the assets, liabilities, owner's equity, revenues, and expenses of a business is the *processing* function.
- Output. The financial statements are the *output*.

FIGURE 2-4 Input, Processing, and Output



SELF-STUDY

LEARNING OBJECTIVES	Key Points to Remember
LO1 Define the accounting elements.	The three key accounting elements are assets, liabilities, and owner's equity. Owner's equity is expanded in LO4 to include revenues, expenses, and drawing.
LO2 Construct the accounting equation.	The accounting equation is Assets = Liabilities + Owner's Equity
LO3 Analyze business transactions.	Three questions must be answered in analyzing business transactions: 1. What happened? 2. Which accounts are affected? 3. How is the accounting equation affected?
business transactions on the accounting equation.	Each transaction affects at least two accounts and one or more of the three basic accounting elements. The transactions described in this chapter can be classified into five groups: 1. Increase in an asset offset by an increase in owner's equity. 2. Increase in an asset offset by a decrease in another asset.
), the characteristic of whom no removed knitting who let (ii) (continued

LEARNING OBJECT	VES Key Points to Remember				
LO4 (concluded)	3. Increase in an asset offset by an increase in a liability.4. Decrease in an asset offset by a decrease in a liability.5. Decrease in an asset offset by a decrease in owner's equity.				
LO5 Prepare and desc the purposes of a simple income sta	sheet can be summarized as follows: STATEMENT PURPOSE				
ment, statement owner's equity, a balance sheet.	Income statement Reports net income or loss				
	Balance sheet Verifies balance of accounting equation Assets = Liabilities + Owner's Equity				
LO6 Define the three	The three basic phases of the accounting process are shown below.				
basic phases of th accounting proce	 Input. Business transactions provide the necessary input. Processing. Recognizing the effect of these transactions on the assets, liabilities, owner's equity, revenues, and expenses of a business is the processing function. Output. The financial statements are the output. 				

DEMONSTRATION PROBLEM

Kenny Young has started his own business, Home and Away Inspections. He inspects property for buyers and sellers of real estate. Young rents office space and has a part-time assistant to answer the phone and help with inspections. The transactions for the month of September are as follows:

- (a) On the first day of the month, Young invested cash by making a deposit in a bank account for the business, \$15,000.
- (b) Paid rent for September, \$300.
- (c) Bought a used truck for cash, \$8,000.
- (d) Purchased tools on account from Crafty Tools, \$3,000.
- (e) Paid electricity bill, \$50.
- (f) Paid two-year premium for liability insurance on truck, \$600.
- (g) Received cash from clients for services performed, \$2,000.
- (h) Paid part-time assistant (wages) for first half of month, \$200.
- (i) Performed inspection services for clients on account, \$1,000.
- (i) Paid phone bill, \$35.
- (k) Bought office supplies costing \$300. Paid \$100 cash and will pay the balance next month, \$200.
- (l) Received cash from clients for inspections performed on account in (i), \$300.
- (m) Paid part-time assistant (wages) for last half of month, \$250.
- (n) Made partial payment on tools bought in (d), \$1,000.

- (o) Earned additional revenues amounting to \$2,000: \$1,400 in cash and \$600 on account.
- (p) Young withdrew cash at the end of the month for personal expenses, \$500.

1. Enter the transactions in an accounting equation similar to the one illustrated below.



- 2. Compute the ending balances for all accounts.
- 3. Prepare an income statement for Home and Away Inspections for the month of September 20--.
- 4. Prepare a statement of owner's equity for Home and Away Inspections for the month of September 20--.
- 5. Prepare a balance sheet for Home and Away Inspections as of September 30, 20--.

SOLUTION 1, 2.

			Ass (Items	sets Owne	ed)				=	: Liabilitie (Amounts O						Equity (Ear	rning	s)	
	Cash	+ Accounts Receivable	+ Suppli	ies +	Prepaid Insuranc	l e +	Tools	+ Tri	uck =	Accounts Payable	+	Kenny Young Capita	J, –	Kenny Young, Drawing		Revenues	- E	xpenses	Description
(a)	15,000											15,00	0						
(b)	(300)																	300	Rent Exp.
(c)	(8,000)							8,0	000										
(d)						,	3,000			3,000									
(e)	(50)																	50	Utilities Exp.
(f)	(600)				600														
(g)	2,000															2,000			Inspect. Fees
(h)	(200)																	200	Wages Exp.
(i)		1,000														1,000			Inspect. Fees
(j)	(35)													4				35	Phone Exp.
(k)	(100)		300							200									
(1)	300	(300)																	
(m)	(250)																	250	Wages Exp.
(n)	(1,000)									(1,000)									
(o)	1,400	600														2,000			Inspect. Fees
(p)	(500)													500					
Bal.	7,665	+ 1,300	+ 300	+	600	+	3,000	+ 8,0	000 =	2,200	+	15,00	0 -	500	+	5,000	-	835	

SOLUTION 3.

Inc	nd Away Inspections come Statement inded September 30, 20	
Revenues:		
Inspection fees		\$ 5,000
Expenses:		
Wages expense	\$450	
Rent expense	300	
Utilities expense	50	
Phone expense	35	
Total expenses		835
Net income		\$ 4,165

SOLUTION 4.

Home and Away Inspo Statement of Owner's For Month Ended Septemb	Equity	
Kenny Young, capital, September 1, 20		\$
Investment during September		15,000
Total investment		\$15,000
Net income for September	\$4,165	
Less withdrawals for September	500	
Increase in capital		3,665
Kenny Young, capital, September 30, 20		\$18,665

SOLUTION 5.

	Bala	Away Inspections ance Sheet nber 30, 20	
Assets		Liabilities	
Cash	\$ 7,665	Accounts payable	\$ 2,200
Accounts receivable	1,300		
Supplies	300	Owner's Equity	
Prepaid insurance	600	Kenny Young, capital	18,665
Tools	3,000		
Truck	8,000		
		Total liabilities and	
Total assets	\$20,865	owner's equity	\$20,865

KEY TERMS

account (23) A separate record used to summarize changes in each asset, liability, and owner's equity of a business.

account title (23) Provides a description of the particular type of asset, liability, owner's equity, revenue, or expense.

Self-Study

- accounting equation (22) The accounting equation consists of the three basic accounting elements: Assets = Liabilities + Owner's Equity.
- accounting period concept (26) The concept that income determination can be made on a periodic basis.
- accounts payable (21) An unwritten promise to pay a supplier for assets purchased or services received.
- accounts receivable (21) An amount owed to a business by its customers as a result of the sale of goods or services.
- asset (21) An item that is owned by a business and will provide future benefits.
- balance sheet (34) Reports assets, liabilities, and owner's equity on a specific date. It is called a balance sheet because it confirms that the accounting equation is in balance.
- business entity (21) An individual, association, or organization that engages in economic activities and controls specific economic resources.
- business entity concept (21) The concept that nonbusiness assets and liabilities are not included in the business entity's accounting records.
- business transaction (23) An economic event that has a direct impact on the business.
- capital (21) Another term for owner's equity, the amount by which the business assets exceed the business liabilities.
- drawing (26) Withdrawals that reduce owner's equity as a result of the owner taking cash or other assets out of the business for personal use.
- expenses (25) The decrease in assets (or increase in liabilities) as a result of efforts to produce revenues.
- fiscal year (26) Any accounting period of 12 months' duration.
- income statement (32) Reports the profitability of business operations for a specific period of time.
- **input** (35) Business transactions provide the necessary input for the accounting information system.
- liability (21) Something owed to another business entity.
- liquidity (32) A measure of the ease with which an asset will be converted to cash.
- net income (26) The excess of total revenues over total expenses for the period.
- net loss (26) The excess of total expenses over total revenues for the period.
- net worth (21) Another term for owner's equity, the amount by which the business assets exceed the business liabilities.
- notes payable (21) A formal written promise to pay a supplier or lender a specified sum of money at a definite future time.
- operating statement (32) Another name for the income statement, which reports the profitability of business operations for a specific period of time.
- **output** (35) The financial statements are the output of the accounting information system.

- **owner's equity** (21) The amount by which the business assets exceed the business liabilities.
- processing (35) Recognizing the effect of transactions on the assets, liabilities, owner's equity, revenues, and expenses of a business.
- profit and loss statement (32) Another name for the income statement, which reports the profitability of business operations for a specific period of time.
- revenues (25) The amount a business charges customers for products sold or services performed.
- statement of financial condition (34) Another name for the balance sheet, which reports assets, liabilities, and owner's equity on a specific date.
- statement of financial position (34) Another name for the balance sheet, which reports assets, liabilities, and owner's equity on a specific date.
- statement of owner's equity (34) Reports beginning capital plus net income less withdrawals to compute ending capital.
- withdrawals (26) Reduce owner's equity as a result of the owner taking cash or other assets out of the business for personal use.

SELF-STUDY TEST QUESTIONS

True/False

- 1. **LO1** Assets are items that are owned by the business and are expected to provide future benefits.
- 2. LO1 Accounts Payable is an example of an asset account.
- 3. **LO1** According to the business entity concept, nonbusiness assets and liabilities are not included in the business's accounting records.
- 4. **LO2** The accounting equation (Assets = Liabilities + Owner's Equity) must always be in balance.
- 5. LO2 When an asset increases, a liability must also increase.
- 6. **LO3** Expenses represent outflows of assets or increases in liabilities as a result of efforts to produce revenues.
- 7. **LO5** When total revenues exceed total expenses, the difference is called net loss.

Multiple Choice

- 1. LO4 An increase to which of these accounts will increase owner's equity?
 - (a) Accounts Payable
- (c) Client Fees

(b) Drawing

- (d) Rent Expense
- 2. **LO4** When delivery revenue is earned in cash, which accounts increase or decrease?
 - (a) Cash increases; Revenue increases.
 - (b) Cash decreases; Revenue increases.
 - (c) Cash decreases; Revenue decreases.
 - (d) Cash does not change; owner's equity increases.

- 3. **LO4** When delivery revenue is earned on account, which accounts increase or decrease?
 - (a) Cash increases; Revenue increases.
 - (b) Accounts Receivable increases; Revenue increases.
 - (c) Accounts Receivable increases; Revenue decreases.
 - (d) Accounts Receivable decreases; Revenue decreases.
- 4. **LO4** When payment is made on an existing debt, which accounts increase or decrease?
 - (a) Cash increases; Accounts Receivable increases.
 - (b) Cash decreases; Accounts Payable increases.
 - (c) Cash increases; Accounts Payable increases.
 - (d) Cash decreases; Accounts Payable decreases.
- 5. LO5 Which of the following accounts does not appear on the income statement?
 - (a) Delivery Fees
- (c) Drawing
- (b) Wages Expense
- (d) Rent Expense



Checkpoint Exercises

1. **LO1** Label each of the following accounts as an asset (A), a liability (L), or owner's equity (OE), using the following format:

Account	Classification
Accounts Receivable	
Accounts Payable	***************************************
Iudy Smith, Capital	

2. **LO2** What is missing from the accounting equation below?

____? ___ = Liabilities + Owner's Equity

3. **LO3/4** What are the effects of the following transactions on the accounting equation? Indicate an increase (+) or decrease (-) under the affected asset, liability, and owner's equity headings.

Transaction	Assets	Liabilities	Owner's Equity
a. Purchase of an asset on account.			
b. Made payment on account			
for transaction (a).		Secretaria de la constanta de	

4. **LO5** Classify the following accounts as assets (A), liabilities (L), owner's equity (OE), revenue (R), or expense (E). Indicate the financial statement on which the account belongs—income statement (IS), statement of owner's equity (SOE), or balance sheet (BS).

Account	Classification	Financial Statement
Accounts Payable	-	
Peggy Welsch, Drawing	Production of the Control of the Con	-
Rent Expense	-	
Sales	Market and the second s	
Equipment		

The answers to the Self-Study Test Questions are at the end of the chapter (page 49).

APPLYING YOUR KNOWLEDGE

LO₅

CengageNowv2 provides "Show Me How" videos for selected exercises and problems. Additional resources, such as Excel templates for completing selected exercises and problems, are available for download from the companion website at Cengage.com.

REVIEW QUESTIONS

1. Why is it necessary to distinguish between business assets and liabilities and nonbusiness assets and liabilities of a single proprietor?

LO1/4 2. Name and define the six major elements of the accounting equation.

3. List the three basic questions that must be answered when analyzing the effects of a business transaction on the accounting equation.

4. What is the function of an income statement?

LOS 5. What is the function of a statement of owner's equity?

6. What is the function of a balance sheet?

7. What are the three basic phases of the accounting process?

SERIES A EXERCISES

E 2-1A (LO1)

ACCOUNTING ELEMENTS Label each of the following accounts as an asset (A), a liability (L), or owner's equity (OE), using the following format:

Item	Account	Classification
Money in bank	Cash	
Office supplies	Supplies	
Money owed	Accounts Payable	
Office chairs	Office Furniture	
Net worth of owner	John Smith, Capital	
Money withdrawn by owner	John Smith, Drawing	
Money owed by customers	Accounts Receivable	

E 2-2A (LO2)

THE ACCOUNTING EQUATION Using the accounting equation, compute the missing elements.

Assets	=	Liabilities	+	Owner's Equity
	=	\$27,000	+	\$17,000
\$32,000	=	\$18,000	+	
\$27,000	=		+	\$20,000

E 2-3A (LO3/4)

Assets following (d): \$32,200

EFFECTS OF TRANSACTIONS (BALANCE SHEET ACCOUNTS) John Sullivan started a business. During the first month (February 20--), the following transactions occurred. Show the effect of each transaction on the accounting equation: Assets = Liabilities + Owner's Equity. After each transaction, show the new totals.

- (a) Invested cash in the business, \$27,000.
- (b) Bought office equipment on account, \$7,500.
- (c) Bought office equipment for cash, \$1,600.
- (d) Paid cash on account to supplier in transaction (b), \$2,300.

E 2-4A (LO3/4)

✓ Assets following (k): \$31,586

EFFECTS OF TRANSACTIONS (REVENUE, EXPENSE, WITHDRAWALS) This exercise is an extension of Exercise 2-3A. Let's assume John Sullivan completed the following additional transactions during February. Show the effect of each transaction on the basic elements of the expanded accounting equation: Assets = Liabilities + Owner's Equity (Capital – Drawing + Revenues – Expenses). After transaction (k), report the totals for each element. Demonstrate that the accounting equation has remained in balance.

- (e) Received cash from a client for professional services, \$1,500.
- (f) Paid office rent for February, \$600.
- (g) Paid February phone bill, \$64.
- (h) Withdrew cash for personal use, \$1,000.
- (i) Performed services for clients on account, \$750.
- (j) Paid wages to part-time employee, \$1,200.
- (k) Received cash for services performed on account in transaction (i), \$400.

E 2-5A (LO1/5)

FINANCIAL STATEMENT ACCOUNTS Label each of the following accounts as an asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E). Indicate the financial statement on which the account belongs—income statement (IS), statement of owner's equity (SOE), or balance sheet (BS)—in a format similar to the following.

Account Classification Financial Statement

Cash

Rent Expense

Accounts Payable

Service Fees

Supplies

Wages Expense

Ramon Martinez, Drawing

Ramon Martinez, Capital

Prepaid Insurance

Accounts Receivable

E 2-6A (LO5)

✓ Capital, 6/30: \$22,000

STATEMENT OF OWNER'S EQUITY REPORTING NET INCOME Betsy Ray started an accounting service on June 1, 20--, by investing \$20,000. Her net income for the month was \$10,000, and she withdrew \$8,000. Prepare a statement of owner's equity for the month of June.

E 2-7A (LO5)
Capital, 6/30: \$9,000

STATEMENT OF OWNER'S EQUITY REPORTING NET LOSS Based on the information provided in Exercise 2-6A, prepare a statement of owner's equity assuming Ray had a net loss of \$3,000.

SERIES A PROBLEMS

P 2-8A (LO1/2)

3: \$32,040 = \$12,910 + \$19,130

THE ACCOUNTING EQUATION Dr. John Salvaggi is a chiropractor. As of December 31, he owned the following property that related to his professional practice.

Cash	\$ 3,500
Office Equipment	6,400
X-ray Equipment	10,220
Laboratory Equipment	6,840

He also owes the following business suppliers:

Chateau Gas Company	\$ 3,430
Aloe Medical Supply Company	4,120

REQUIRED

1. From the preceding information, compute the accounting elements and enter them in the accounting equation shown as follows.

Assets	=	Liabilities	+	Owner's Equity
-			+	

- 2. During January, the assets increase by \$8,540, and the liabilities increase by \$3,360. Compute the resulting accounting equation.
- 3. During February, the assets decrease by \$3,460, and the liabilities increase by \$2,000. Compute the resulting accounting equation.

P 2-9A (LO3/4)

✓ Total cash following (g): \$12,950

EFFECT OF TRANSACTIONS ON ACCOUNTING EQUATION Jay Pembroke started a business. During the first month (April 20--), the following transactions occurred.

- (a) Invested cash in business, \$18,000.
- (b) Bought office supplies for \$4,600: \$2,000 in cash and \$2,600 on account.
- (c) Paid one-year insurance premium, \$1,200.
- (d) Earned revenues totaling \$3,300: \$1,300 in cash and \$2,000 on account.
- (e) Paid cash on account to the company that supplied the office supplies in transaction (b), \$2,300.
- (f) Paid office rent for the month, \$750.
- (g) Withdrew cash for personal use, \$100.

REQUIRED

Show the effect of each transaction on the individual accounts of the expanded accounting equation: Assets = Liabilities + Owner's Equity (Capital - Drawing + Revenues - Expenses). After transaction (g), report the totals for each element. Demonstrate that the accounting equation has remained in balance.

P 2-10A (LO5)

Net income: \$2,550

INCOME STATEMENT Based on Problem 2-9A, prepare an income statement for Jay Pembroke for the month of April 20--.

P 2-11A (LO5) Capital, 4/30: \$20,450 STATEMENT OF OWNER'S EQUITY Based on Problem 2-9A, prepare a statement of owner's equity for Jay Pembroke for the month of April 20--.

P 2-12A (LO5)

Total assets, 4/30: \$20,750

BALANCE SHEET Based on Problem 2-9A, prepare a balance sheet for Jay Pembroke as of April 30, 20--.

SERIES B EXERCISES

E 2-1B (LO1)

ACCOUNTING ELEMENTS Label each of the following accounts as an asset (A), liability (L), or owner's equity (OE) using the following format.

Account	Classification
Cash	
Accounts Payable	
Supplies	
Bill Jones, Drawing	
Prepaid Insurance	
Accounts Receivable	
Bill Jones, Capital	

E 2-2B (LO2)

THE ACCOUNTING EQUATION Using the accounting equation, compute the missing elements.

Assets	==	Liabilities	+	Owner's Equity
NAME OF TAXABLE PARTY.	=	\$20,000	+	\$ 5,000
\$30,000	=	\$15,000	+	***************************************
\$20,000	=		+	\$10,000

E 2-3B (LO3/4)

✓ Assets following (d): \$32,500

EFFECTS OF TRANSACTIONS (BALANCE SHEET ACCOUNTS) Jon Wallace started a business. During the first month (March 20--), the following transactions occurred. Show the effect of each transaction on the accounting equation: *Assets = Liabilities + Owner's Equity*. After each transaction, show the new account totals.

- (a) Invested cash in the business, \$30,000.
- (b) Bought office equipment on account, \$4,500.
- (c) Bought office equipment for cash, \$1,600.
- (d) Paid cash on account to supplier in transaction (b), \$2,000.

E 2-4B (LO3/4)

Assets following (k): \$34,032

EFFECTS OF TRANSACTIONS (REVENUE, EXPENSE, WITHDRAWALS) This exercise is an extension of Exercise 2-3B. Let's assume Jon Wallace completed the following additional transactions during March. Show the effect of each transaction on the basic elements of the expanded accounting equation: Assets = Liabilities + Owner's Equity (Capital – Drawing + Revenues – Expenses). After transaction (k), report the totals for each element. Demonstrate that the accounting equation has remained in balance.

- (e) Performed services and received cash, \$3,000.
- (f) Paid rent for March, \$1,000.
- (g) Paid March phone bill, \$68.

(continued)

- (h) Jon Wallace withdrew cash for personal use, \$800.
- (i) Performed services for clients on account, \$900.
- (j) Paid wages to part-time employee, \$500.
- (k) Received cash for services performed on account in transaction (i), \$500.

E 2-5B (LO1/5)

FINANCIAL STATEMENT ACCOUNTS Label each of the following accounts as an asset (A), liability (L), owner's equity (OE), revenue (R), or expense (E). Indicate the financial statement on which the account belongs—income statement (IS), statement of owner's equity (SOE), or balance sheet (BS)—in a format similar to the following.

Account	Classification	Financial Statement
Cash		
Rent Expense		
Accounts Payable		
Service Fees		
Supplies		
Wages Expense		
Amanda Wong, Drawing		
A		

Amanda Wong, Capital
Prepaid Insurance
Accounts Receivable

E 2-6B (LO5)

✓ Capital, 6/30: \$14,000

STATEMENT OF OWNER'S EQUITY REPORTING NET INCOME Efran Lopez started a financial consulting service on June 1, 20--, by investing \$15,000. His net income for the month was \$6,000, and he withdrew \$7,000 for personal use. Prepare a statement of owner's equity for the month of June.

E 2-7B (LO5)

✓ Capital, 6/30: \$6,000

STATEMENT OF OWNER'S EQUITY REPORTING NET LOSS Based on the information provided in Exercise 2-6B, prepare a statement of owner's equity assuming Lopez had a net loss of \$2,000.

SERIES B PROBLEMS

P 2-8B (LO1/2)

✓ 3: \$25,235 = \$10,165 + \$15,070

THE ACCOUNTING EQUATION Dr. Patricia Parsons is a dentist. As of January 31, Parsons owned the following property that related to her professional practice:

Cash	\$3,560
Office Equipment	4,600
X-ray Equipment	8,760
Laboratory Equipment	5,940
	1.

She also owes the following business suppliers:

Cupples Gas Company	\$1,815
Swan Dental Lab	2,790

REQUIRED

1. From the preceding information, compute the accounting elements and enter them in the accounting equation as shown below.

Assets	=	Liabilities	+	Owner's Equity
	=		+	

- 2. During February, the assets increase by \$4,565, and the liabilities increase by \$3,910. Compute the resulting accounting equation.
- 3. During March, the assets decrease by \$2,190, and the liabilities increase by \$1,650. Compute the resulting accounting equation.

EFFECT OF TRANSACTIONS ON ACCOUNTING EQUATION David Segal started a business. During the first month (October 20--), the following transactions occurred.

- (a) Invested cash in the business, \$15,000.
- (b) Bought office supplies for \$3,800: \$1,800 in cash and \$2,000 on account.
- (c) Paid one-year insurance premium, \$1,000.
- (d) Earned revenues amounting to \$2,700: \$1,700 in cash and \$1,000 on account.
- (e) Paid cash on account to the company that supplied the office supplies in transaction (b), \$1,800.
- (f) Paid office rent for the month, \$650.
- (g) Withdrew cash for personal use, \$150.

REQUIRED

Show the effect of each transaction on the individual accounts of the expanded accounting equation: Assets = Liabilities + Owner's Equity (Capital - Drawing + Revenues - Expenses). After transaction (g), report the totals for each element. Demonstrate that the accounting equation has remained in balance.

INCOME STATEMENT Based on Problem 2-9B, prepare an income statement for David Segal for the month of October 20--.

STATEMENT OF OWNER'S EQUITY Based on Problem 2-9B, prepare a statement of owner's equity for David Segal for the month of October 20--.

BALANCE SHEET Based on Problem 2-9B, prepare a balance sheet for David Segal as of October 31, 20--.

P 2-10B (LO5) ✓ Net income: \$2,050

P 2-9B

(LO3/4)√ Total cash following (g): \$11,300

P 2-11B (LO5) √ Capital, 10/31: \$16,900

P 2-12B (LO5) √ Total assets, 10/31: \$17,100

CHECK LIST

Managing Planning **Drafting** Break Revising Managing

MANAGING YOUR WRITING

Write a brief memo that explains the differences and similarities between expenses and withdrawals.

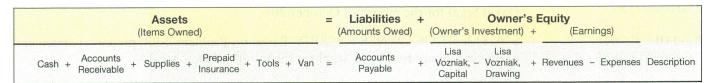
MASTERY PROBLEM

✓ Cash following (p): \$3,105 ✓ Revenue following (p): \$2,100 Lisa Vozniak started her own business, We Do Windows. She offers interior and exterior window cleaning for local area residents. Lisa rents a garage to store her tools and cleaning supplies and has a part-time assistant to answer the phone and handle third-story work. (Lisa is afraid of heights.) The transactions for the month of July are as follows:

- (a) Lisa invested cash by making a deposit in a bank account for the business, \$8,000.
- (b) Paid rent for July, \$150.
- (c) Purchased a used van for cash, \$5,000.
- (d) Purchased tools on account from Clean Tools, \$600.
- (e) Purchased cleaning supplies that cost \$300. Paid \$200 cash and will pay the balance next month, \$100.
- (f) Paid part-time assistant (wages) for first half of month, \$100.
- (g) Paid for advertising, \$75.
- (h) Paid two-year premium for liability insurance on van, \$480.
- (i) Received cash from clients for services performed, \$800.
- (j) Performed cleaning services for clients on account, \$500.
- (k) Paid phone bill, \$40.
- (l) Received cash from clients for window cleaning performed on account in transaction (j), \$200.
- (m) Paid part-time assistant (wages) for last half of month, \$150.
- (n) Made partial payment on tools purchased in transaction (d), \$200.
- (o) Earned additional revenues amounting to \$800: \$600 in cash and \$200 on account.
- (p) Vozniak withdrew cash at the end of the month for personal expenses, \$100.

REQUIRED

1. Enter the above transactions in an accounting equation similar to the one illustrated below.



- 2. After transaction (p), compute the balance of each account.
- 3. Prepare an income statement for We Do Windows for the month of July 20--.
- 4. Prepare a statement of owner's equity for We Do Windows for the month of July 20--.
- 5. Prepare a balance sheet for We Do Windows as of July 31, 20--.

This problem challenges you to apply your cumulative accounting knowledge to move a step beyond the material in the chapter.

CHALLENGE PROBLEM

In this chapter, you learned about three important financial statements: the income statement, statement of owner's equity, and balance sheet. As mentioned in the margin note on page 34, most firms also prepare a statement of cash flows. Part of this statement reports the cash received from customers and cash paid for goods and services.

✓ Cash difference: \$2,165

REQUIRED

Take another look at the Demonstration Problem for Kenny Young's "Home and Away Inspections." Note that when revenues are measured based on the amount earned, and expenses are measured based on the amount incurred, net income for the period was \$4,165. Now, compute the difference between cash received from customers and cash paid to suppliers of goods and services by completing the form provided below. Are these measures different? Which provides a better measure of profitability?

Cash from customers	
Cash paid for wages	
Cash paid for rent	
Cash paid for utilities	
Cash paid for insurance	
Cash paid for supplies	
Cash paid for phone	
Total cash paid for operating items	
Difference between cash received from	
customers and cash paid for goods and services	

ANSWERS TO SELF-STUDY TEST QUESTIONS

ue/raise		2. Assets = Liabilities + Owner's Equity			
t. To 1902 to high at 090		3. Transaction	Assets Liabi	lities Owner's Equity	
2. F (Accounts Payable is a	liability.)	a. Purchase of	1210326 6 83116	BE THE JOST MAN	
		an asset on account.	н авар и се за пове В се на	eni nombre esti i Festiscobre	
4. T 5. F (Other changes could c	occur: capital could	b. Made pay-		253180006	
increase, revenue could in		ment on account for			
5. T 7. F (net income)		transaction	bns som led te	LOS Popuration	
• 1 (flet flicoffie)		101 ca 214 (a).			
lultiple Choice		4. Account	Classification	Financial Statement	
c 2. a 3. b 4.	d 5. c	Accounts Payable	L	BS	
heckpoint Exercises		Peggy Welsch, Drawing	OE	SOE	
. Account	Classification	Rent Expense	E	IS	
Accounts Receivable Accounts Payable	A L. Ozerla	Sales	R	IS	
Judy Smith Capital	OE.	Fauipment	A	BS	