INTRODUCTION TO ACCOUNTING AND BUSINESS

objectives

After studying this chapter, you should be able to:

1. Describe the nature of a business.
2. Describe the role of accounting in business.
3. Describe the importance of business ethics and the basic principles of proper ethical conduct.
4. Describe the profession of accounting.
5. Summarize the development of accounting principles and relate them to practice.
6. State the accounting equation and define each element of the equation.
7. Explain how business transactions can be stated in terms of the resulting changes in the basic elements of the accounting equation.
8. Describe the financial statements of a proprietorship and explain how they interrelate.
9. Use the ratio of liabilities to owner's equity to analyze the ability of a business to withstand poor business conditions.
Do you use accounting? Yes, we all use accounting information in one form or another. For example, when you think about buying a car, you use accounting-type information to determine whether you can afford it and whether to lease or buy. Similarly, when you decided to attend college, you considered the costs (the tuition, textbooks, and so on). Most likely, you also considered the benefits (the ability to obtain a higher-paying job or a more desirable job).

Is accounting important to you? Yes, accounting is important in your personal life as well as your career, even though you may not become an accountant. For example, assume that you are the owner/manager of a small Mexican restaurant and are considering opening another restaurant in a neighboring town. Accounting information about the restaurant will be a major factor in your deciding whether to open the new restaurant and the bank’s deciding whether to finance the expansion.

Our primary objective in this text is to illustrate basic accounting concepts that will help you to make good personal and business decisions. We begin by discussing what a business is, how it operates, and the role that accounting plays.

Nature of a Business

You can probably list some examples of companies with which you have recently done business. Your examples might be large companies, such as Coca-Cola, Dell Computer, or Amazon.com. They might be local companies, such as gas stations or grocery stores, or perhaps employers. They might be restaurants, law firms, or medical offices. What do all these examples have in common that identify them as businesses?

In general, a business is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. Businesses come in all sizes, from a local coffee house to a DaimlerChrysler, which sells several billion dollars worth of cars and trucks each year. A business’s customers are individuals or other businesses who purchase goods or services in exchange for money or other items of value. In contrast, a church is not a business because those who receive its services are not obligated to pay for them.

The objective of most businesses is to maximize profits. Profit is the difference between the amounts received from customers for goods or services provided and the amounts paid for the inputs used to provide the goods or services. Some businesses operate with an objective other than to maximize profits. The objective of such nonprofit businesses is to provide some benefit to society, such as medical research or conservation of natural resources. In other cases, governmental units such as cities operate water works or sewage treatment plants on a nonprofit basis. We will focus in this text on businesses operating to earn a profit. Keep in mind, though, that many of the same concepts and principles apply to nonprofit businesses as well.

Types of Businesses

There are three different types of businesses that are operated for profit: manufacturing, merchandising, and service businesses. Each type of business has unique characteristics.

Manufacturing businesses change basic inputs into products that are sold to individual customers. Examples of manufacturing businesses and some of their products are as follows.

1A complete glossary of terms appears at the end of the text.
Manufacturing Business | Product
--- | ---
General Motors | Cars, trucks, vans
Intel | Computer chips
Boeing | Jet aircraft
Nike | Athletic shoes and apparel
Coca-Cola | Beverages
Sony | Stereos and televisions

*Merchandising businesses* also sell products to customers. However, rather than making the products, they purchase them from other businesses (such as manufacturers). In this sense, merchandisers bring products and customers together. Examples of merchandising businesses and some of the products they sell are shown below.

| Merchandising Business | Product |
--- | ---
Wal-Mart | General merchandise
Toys “R” Us | Toys
Circuit City | Consumer electronics
Lands’ End | Apparel
Amazon.com | Internet books, music, video retailer

*Service businesses* provide services rather than products to customers. Examples of service businesses and the types of services they offer are shown below.

| Service Business | Service |
--- | ---
Disney | Entertainment
Delta Air Lines | Transportation
Marriott Hotels | Hospitality and lodging
Merrill Lynch | Financial advice
Sprint | Telecommunications

Roughly eight out of every ten workers in the United States are service providers.

**Types of Business Organizations**

The common forms of business organization are proprietorship, partnership, corporation, or limited liability corporation. In the following paragraphs, we briefly describe each form and discuss its advantages and disadvantages.

A *proprietorship* is owned by one individual. More than 70% of the businesses in the United States are organized as proprietorships. The popularity of this form is due to the ease and the low cost of organizing. The primary disadvantage of proprietorships is that the financial resources available to the business are limited to the individual owner’s resources. Small local businesses such as hardware stores, repair shops, laundries, restaurants, and maid services are often organized as proprietorships.

As a business grows and more financial and managerial resources are needed, it may become a partnership. A *partnership* is owned by two or more individuals. Like proprietorships, small local businesses such as automotive repair shops, music stores, beauty salons, and clothing stores may be organized as partnerships. Currently, about 10% of the businesses in the United States are organized as partnerships.

A *corporation* is organized under state or federal statutes as a separate legal taxable entity. The ownership of a corporation is divided into shares of stock. A corporation issues the stock to individuals or other businesses, who then become owners or stockholders of the corporation.

A primary advantage of the corporate form is the ability to obtain large amounts of resources by issuing stock. For this reason, most companies that require large investments in equipment and facilities are organized as corporations. For example, Toys “R” Us has raised over $400 million by issuing shares of common stock to finance its operations. Other examples of corporations include *General Motors*, *Ford*, *International Business Machines (IBM)*, *Coca-Cola*, and *General Electric*. 
About 20% of the businesses in the United States are organized as corporations. Given that most large companies are organized as corporations, over 90% of the total dollars of business receipts are received by corporations. Thus, corporations have a major influence on the economy.

A limited liability corporation combines attributes of a partnership and a corporation in that it is organized as a corporation, but it can elect to be taxed as a partnership. Thus, its owners’ (or members’) liability is limited to their investment in the business, and its income is taxed when the owners report it on their individual tax returns.

The three types of businesses we discussed earlier—manufacturing, merchandising, and service—may be either proprietorships, partnerships, corporations, or limited liability corporations. However, because of the large amount of resources required to operate a manufacturing business, most manufacturing businesses are corporations. Likewise, most large retailers such as Wal-Mart, Sears, and JCPenney are corporations.

Business Strategies

How does a business decide which products or services to offer its customers? For example, should Best Buy offer warranty and repair services to its customers? Many factors influence this decision, but ultimately the decision is made on the basis of whether it is consistent with the overall business strategy of the company.

A business strategy is an integrated set of plans and actions designed to enable the business to gain an advantage over its competitors, and in doing so, to maximize its profits. The two basic strategies a business may use are a low-cost strategy or a differentiation strategy.

Under a low-cost strategy, a business designs and produces products or services of acceptable quality at a cost lower than that of its competitors. Wal-Mart and Southwest Airlines are examples of businesses with a low-cost strategy. Such businesses often sell no-frills, standardized products to the most typical customer in the industry. Following this strategy, businesses must continually focus on lowering costs.

Businesses may try to achieve lower costs in a variety of ways. For example, a business may employ strict budgetary controls, use sophisticated training programs, implement simple manufacturing technologies, or enter into cost-saving supplier relationships. Such supplier relationships may involve linking the supplier’s production process directly to the client’s production processes to minimize inventory costs, variations in raw materials, and record keeping costs.

A primary concern of a business using a low-cost strategy is that a competitor may achieve even lower costs by replicating the low costs or developing technological advances. Another concern is that competitors may differentiate their products in such a way that customers no longer desire a standardized, no-frills product. For example, local pharmacies most often try to compete with Wal-Mart on the basis of personalized service rather than cost.

Under a differentiation strategy, a business designs and produces products or services that possess unique attributes or characteristics for which customers are willing to pay a premium price. For the differentiation strategy to be successful, a product or service must be truly unique or perceived as unique in quality, reliability, image, or design. To illustrate, Maytag attempts to differentiate its appliances on the basis of reliability, while Tommy Hilfiger differentiates its clothing on the basis of image.

Businesses using a differentiation strategy often use information systems to capture and analyze customer buying habits and preferences. For example, many grocery stores such as Kroger and Safeway issue magnetic cards to preferred customers that allow the consumer to receive special discounts on purchases. In addition to establishing brand loyalty, the cards allow the stores to track consumer preferences and buying habits for use in purchasing and advertising campaigns.

Companies may enhance differentiation by investing in manufacturing and service technologies, such as flexible manufacturing methods that allow timely product design and delivery. Some companies use marketing and sales efforts to promote
product differences. Other companies use unique credit-granting arrangements, emphasize personal relationships with customers, or offer extensive training and after-sales service programs for customers.

A business using a differentiation strategy wants customers to pay a premium price for the differentiated features of its products. However, a business may provide features that exceed the customers’ needs. In this case, competitors may be able to offer customers less differentiated products at lower costs. Also, customers’ perceptions of the differentiated features may change. As a result, customers may not be willing to continue to pay a premium price for the products. For example, as Tommy Hilfiger clothing becomes more commonplace, customers may be unwilling to pay a premium price for Hilfiger clothing. Over time, customers may also become better educated about the products and the value of the differentiated features. For example, IBM personal computers were once viewed as being differentiated on quality. However, as consumers have become better educated and more experienced with personal computers, Dell computers have also become perceived as being of high quality.

A business may attempt to implement a combination strategy that includes elements of both the low-cost and differentiation strategies. That is, a business may attempt to develop a differentiated product at competitive, low-cost prices. For example, Andersen Windows allows customers to design their own windows through the use of its proprietary manufacturing software. By using flexible manufacturing, Andersen Windows can produce a variety of windows in small quantities with a low or moderate cost. Thus, Andersen windows sell at a higher price than standard low-cost windows but at a lower price than fully customized windows built on site.

Exhibit 1 summarizes the characteristics of the low-cost, differentiation, and combination strategies. In addition, some common examples of businesses that employ each strategy are also listed.

**Exhibit 1  Business Strategies and Industries**

<table>
<thead>
<tr>
<th>Business Strategy</th>
<th>Industry</th>
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<tbody>
<tr>
<td>Low cost</td>
<td>Airline</td>
</tr>
<tr>
<td></td>
<td>Southwest</td>
</tr>
<tr>
<td>Differentiated</td>
<td>Virgin Atlantic</td>
</tr>
<tr>
<td>Combination</td>
<td>Delta</td>
</tr>
</tbody>
</table>

As you might expect, a danger of a business using a combination strategy is that its products might not adequately satisfy either end of the market. That is, because its products are differentiated, it cannot establish itself as the low-cost leader, and at the same time, its products may not be differentiated enough that customers are willing to pay a premium price. In other words, the business may become “stuck in the middle.” For example, J.C. Penney has difficulty competing as a low-cost leader against Wal-Mart, Kmart, Goody’s Family Clothing, Fashion USA, and T.J. Maxx. At the same time, J.C. Penney cannot adequately differentiate its stores and merchandise from such competitors as The Gap, Old Navy, Eddie Bauer, and Talbot’s so that it can charge higher prices.
A business may also attempt to implement different strategies for different markets. For example, Toyota segments the market for automobiles by offering the Lexus to image- and quality-conscious buyers. To reinforce this image, Toyota developed a separate dealer network. At the same time, Toyota offers a low-cost automobile, the Echo, to price-sensitive buyers.

**Value Chain of a Business**

Once a business has chosen a strategy, it must implement the strategy in its value chain. A *value chain* is the way a business adds value for its customers by processing inputs into a product or service, as shown in Exhibit 2.

**Exhibit 2 The Value Chain**

To illustrate, Delta Air Lines’ value chain consists of taking inputs, such as people, aircraft, and equipment, and processing these inputs into a service of transporting goods and passengers throughout the world. The extent to which customers value Delta’s passenger service is reflected by the air fares Delta is able to charge as well as passenger load factors (percentage of seats occupied). For example, the extent to which Delta can, on average, charge higher fares than discount airlines, such as AirTran, implies that passengers value Delta’s services more than AirTran’s. These services may include newer, more comfortable aircraft, the ability to earn frequent flyer miles, more convenient passenger schedules, passenger lounges for frequent flyers, and international connections.

A business’s value chain can be divided into primary and supporting processes. Primary processes are those that are directly involved in creating value for customers. Examples of primary processes include manufacturing, selling, and customer service. Supporting processes are those that facilitate the primary processes. Examples of support processes include purchasing and personnel. For Delta Air Lines, primary processes would include aircraft maintenance, baggage handling, ticketing, and flight operations. Secondary processes for Delta Air Lines would include the accounting and finance functions, contracting for fuel deliveries, and investor relations.

**Business Stakeholders**

A *business stakeholder* is a person or entity having an interest in the economic performance of the business. These stakeholders normally include the owners, managers, employees, customers, creditors, and the government.

The *owners* who have invested resources in the business clearly have an interest in how well the business performs. Most owners want to get the most economic value for their investments. To the extent that the business is profitable, owners will expect to share in the business profits. Since owners may eventually decide to sell their business, they also have an interest in the total economic worth of the business. This economic worth may reflect results of past profits as well as prospects for future profits.

The *managers* are those individuals who the owners have authorized to operate the business. Managers are primarily evaluated on the economic performance of the business. The managers of poor-performing businesses are often fired by the owners. Thus, managers have an incentive to maximize the economic value of the

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2The value chain is described and illustrated in most management textbooks.
business. Owners may offer managers salary contracts that are tied directly to how well the business performs. For example, a manager might receive a percent of the profits or a percent of the increase in profits. Such contracts are often referred to as profit-sharing plans.

The employees provide services to the business in exchange for a paycheck. The employees have an interest in the economic performance of the business because their jobs depend upon it. During business downturns, it is not unusual for a business to lay off workers for extended periods of time. Whenever a business fails, the employees lose their jobs permanently. Employee labor unions often use the good economic performance of a business to argue for wage increases. In contrast, businesses often cite poor economic performance as a reason for decreasing wages or denying raises.

The customers may also have an interest in the continued success of a business. For example, if Apple Computer were to fail, customers might not be able to get hardware and software for their computers. Likewise, customers who purchase advance tickets on Southwest Airlines have an interest in whether Southwest will continue in business. Frequent flyers on Eastern Airlines lost their accumulated frequent-flyer points when Eastern went out of business.

Like the owners, the creditors invest resources in the business by extending credit, such as a loan. They, too, have an interest in how well the business performs. In order for the creditors to recover their investment, the business must generate enough cash to pay them back. In addition, creditors view the business as their customer and thus have a stake in the continued success of the business.

Various governments have an interest in the economic performance of businesses. City, county, state, and federal governments collect taxes from businesses within their jurisdictions. The better a business does, the more taxes the government can collect. In addition, workers are taxed on their wages. In contrast, workers who are laid off and are unemployed can file claims for unemployment compensation, which results in a financial burden for the government. City and state governments often provide incentives for businesses to locate in their jurisdictions.

## SUCCESSFUL ENTREPRENEURS

What are the characteristics of entrepreneurs who successfully start and manage a new business?

It goes without saying that an entrepreneur must have a thorough technical knowledge of the business. For example, a successful computer consultant must have a thorough knowledge of computers. Entrepreneurs must also have basic management skills, such as the ability to organize and interact with others. Terms that are often used to describe entrepreneurs are listed below.

### Terms

<table>
<thead>
<tr>
<th>Terms</th>
<th>Definitions</th>
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</thead>
<tbody>
<tr>
<td>Vision</td>
<td>Spirit of adventure</td>
</tr>
<tr>
<td>Perseverance</td>
<td>Need for achievement</td>
</tr>
<tr>
<td>Independent</td>
<td>Self-starter</td>
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<tr>
<td>Self-confident</td>
<td>Sense of commitment</td>
</tr>
<tr>
<td>Risk taker</td>
<td>Willingness to make personal sacrifices</td>
</tr>
<tr>
<td>High energy level</td>
<td>Communication skills</td>
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<tr>
<td>Motivated</td>
<td></td>
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<tr>
<td>Personal drive</td>
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</tbody>
</table>

Examples of some well-known entrepreneurs and their companies are listed below.

<table>
<thead>
<tr>
<th>Entrepreneur</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jeffrey Yang</td>
<td>Yahoo!</td>
</tr>
<tr>
<td>Henry Ford</td>
<td>Ford Motor Company</td>
</tr>
<tr>
<td>George Eastman</td>
<td>Kodak</td>
</tr>
<tr>
<td>King C. Gillette</td>
<td>Gillette Company</td>
</tr>
<tr>
<td>Steven Jobs</td>
<td>Apple Computer</td>
</tr>
<tr>
<td>Bill Gates</td>
<td>Microsoft</td>
</tr>
<tr>
<td>Frederick Smith</td>
<td>Federal Express</td>
</tr>
<tr>
<td>Sam Walton</td>
<td>Wal-Mart</td>
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</tbody>
</table>

Examples of entrepreneurs also include the owners of many small businesses in your community, from local restaurants to video rental stores.
Chapter 1 • Introduction to Accounting and Business

The Role of Accounting in Business

objective 2
Describe the role of accounting in business.

What is the role of accounting in business? The simplest answer to this question is that accounting provides information for managers to use in operating the business. In addition, accounting provides information to other stakeholders to use in assessing the economic performance and condition of the business.

In a general sense, accounting can be defined as an information system that provides reports to stakeholders about the economic activities and condition of a business. As we indicated earlier in this chapter, we will focus our discussions on accounting and its role in business. However, many of the concepts in this text apply also to individuals, governments, and other types of organizations. For example, individuals must account for activities such as hours worked, checks written, and bills due. Stakeholders for individuals include creditors, dependents, and the government. A main interest of the government is making sure that individuals pay the proper taxes.

You may think of accounting as the “language of business.” This is because accounting is the means by which business information is communicated to the stakeholders. For example, accounting reports summarizing the profitability of a new product help Coca-Cola’s management decide whether to continue selling the product. Likewise, financial analysts use accounting reports in deciding whether to recommend the purchase of Coca-Cola’s stock. Banks use accounting reports in determining the amount of credit to extend to Coca-Cola. Suppliers use accounting reports in deciding whether to offer credit for Coca-Cola’s purchases of supplies and raw materials. State and federal governments use accounting reports as a basis for assessing taxes on Coca-Cola.

The process by which accounting provides information to business stakeholders is illustrated in Exhibit 3. A business must first identify its stakeholders. It must then assess the various informational needs of those stakeholders and design its accounting system to meet those needs. Finally, the accounting system records the economic data about business activities and events, which the business reports to the stakeholders according to their informational needs.

Stakeholders use accounting reports as a primary source of information on which they base their decisions. They use other information as well. For example, in deciding whether to extend credit to an appliance store, a banker might use economic forecasts to assess the future demand for the store’s products. During periods of economic downturn, the demand for consumer appliances normally declines. The banker might inquire about the ability and reputation of the managers of the business. For small corporations, bankers may require major stockholders to personally guarantee the loans of the business. Finally, bankers might consult industry publications that rank similar businesses as to their quality of products, customer satisfaction, and future prospects for growth.

Business Ethics

objective 3
Describe the importance of business ethics and the basic principles of proper ethical conduct.

Individuals may have different views about what is “right” and “wrong” in a given situation. For example, you may believe it is wrong to copy another student’s homework and hand it in as your own. Other students may feel that it is acceptable to copy homework if the instructor has no stated rule against it. Unfortunately, business managers sometimes find themselves in situations where they feel pressure to violate personal ethics. For example, managers of Sears automotive service departments were accused of recommending unnecessary repairs and overcharging customers for actual repairs in order to meet company goals and earn bonuses.
The moral principles that guide the conduct of individuals are called **ethics**. Regardless of differences among individuals, proper ethical conduct implies a behavior that considers the impact of one’s actions on society and others. In other words, proper ethical conduct implies that you not only consider what’s in your best interest, but also what’s in the best interests of others.

Ethical conduct is good business. For example, an automobile manufacturer that fails to correct a safety defect to save costs may later lose sales due to lack of consumer confidence. Likewise, a business that pollutes the environment may find itself the target of lawsuits and customer boycotts.

Businesspeople should work within an ethical framework. Although an ethical framework is based on individual experiences and training, there are a number of sound principles that form the foundation for ethical behavior:

1. **Avoid small ethical lapses.** Small ethical lapses may appear harmless in and of themselves. Unfortunately, such lapses can compromise your work. Small ethical lapses can build up and lead to larger consequences later.

2. **Focus on your long-term reputation.** One characteristic of an ethical dilemma is that it places you under severe short-term pressure. The ethical dilemma is created by the stated or unstated threat that failure to “go along” may result in undesirable consequences. You should respond to ethical dilemmas by minimizing the short-term pressures and focusing on long-term reputation instead. Your reputation is very valuable. You will lose your effectiveness if your reputation becomes tarnished.

3. **You may suffer adverse personal consequences for holding to an ethical position.** In some unethical organizations, managers have endured career setbacks for not budging from their ethical positions. Some managers have resigned because they were unable to support management in what they perceived as unethical behavior. Thus, in the short term, ethical behavior can sometimes adversely affect your career.

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**Real World**

Stanley James Cardiges, the former top U.S. sales representative for American Honda, admitted to receiving $2 million to $5 million in illegal kickbacks from dealers. After being sentenced to five years in prison, he admitted to falling into a pattern of unethical behavior early in his career.

**Point of Interest**

Most colleges and universities publish a Student Code of Conduct that sets forth the ethical conduct expected of students.

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*Integrity in Business* items and end-of-chapter ethics discussion cases are provided throughout this text to focus attention on the importance of proper ethical conduct in business.
Profession of Accounting

objectives 4
Describe the profession of accounting.

Accountants engage in either private accounting or public accounting. Accountants employed by a business firm or a not-for-profit organization are said to be engaged in private accounting. Accountants and their staff who provide services on a fee basis are said to be employed in public accounting.

Because all functions within a business use accounting information, experience in private or public accounting provides a solid foundation for a career. Many positions in industry and in government agencies are held by individuals with accounting backgrounds. For example, in a Special Bonus Issue on “The Corporate Elite,” Business Week reported the career paths for the chief executives of the 1,000 largest public corporations. These career paths are shown in Exhibit 4.
Private Accounting

The scope of activities and duties of private accountants varies widely. Private accountants are frequently called management accountants. If they are employed by a manufacturer, they may be referred to as industrial or cost accountants. The chief accountant in a business may be called the controller. Various state and federal agencies and other not-for-profit agencies also employ accountants.

The Institute of Certified Management Accountants, an affiliate of the Institute of Management Accountants (IMA), sponsors the Certified Management Accountant (CMA) program. The CMA certificate is evidence of competence in management accounting. Becoming a CMA requires a college degree, two years of experience, and successful completion of a two-day examination. Continuing professional education is required for renewal of the CMA certificate. In addition, members of the IMA must adhere to standards of ethical conduct.

The Institute of Internal Auditors sponsors a similar program for internal auditors. Internal auditors are accountants who review the accounting and operating procedures prescribed by their firms. Accountants who specialize in internal auditing may be granted the Certified Internal Auditor (CIA) certificate.

Public Accounting

In public accounting, an accountant may practice as an individual or as a member of a public accounting firm. Public accountants who have met a state’s education, experience, and examination requirements may become Certified Public Accountants (CPAs).

The requirements for obtaining a CPA certificate differ among the various states. All states require a college education in accounting, and most states require 150 semester hours of college credit. In addition, a candidate must pass an examination prepared by the American Institute of Certified Public Accountants (AICPA).

Most states do not permit individuals to practice as CPAs until they have had from one to three years’ experience in public accounting. Some states, however, accept similar employment in private accounting as equivalent experience. All states require continuing professional education and adherence to standards of ethical conduct.

Specialized Accounting Fields

You may think that all accounting is the same. However, you will find several specialized fields of accounting in practice. The two most common are financial accounting and managerial accounting. Other fields include cost accounting, environmental...

**Financial accounting** is primarily concerned with the recording and reporting of economic data and activities for a business. Although such reports provide useful information for managers, they are the primary reports for owners, creditors, governmental agencies, and the public. For example, if you wanted to buy some stock in **PepsiCo**, **American Airlines**, or **McDonald's**, how would you know in which company to invest? One way is to review financial reports and compare the financial performance and condition of each company. The purpose of financial accounting is to provide such reports.

**Managerial accounting**, or **management accounting**, uses both financial accounting and estimated data to aid management in running day-to-day operations and in planning future operations. Management accountants gather and report information that is relevant and timely to the decision-making needs of management. For example, management might need information on alternative ways to finance the construction of a new building. Alternatively, management might need information on whether to expand its operations into a new product line. Thus, reports to management can differ widely in form and content.

**Generally Accepted Accounting Principles**

If the management of a company could record and report financial data as it saw fit, comparisons among companies would be difficult, if not impossible. Thus, financial accountants follow **generally accepted accounting principles (GAAP)** in preparing reports. These reports allow investors and other stakeholders to compare one company to another.

To illustrate the importance of generally accepted accounting principles, assume that each sports conference in college football used different rules for counting touchdowns. For example, assume that the Pacific Athletic Conference (PAC 10) counted a touchdown as six points and the Atlantic Coast Conference (ACC) counted a touchdown as two points. It would be difficult to evaluate the teams under such different scoring systems. A standard set of rules and a standard scoring system help fans compare teams across conferences. Likewise, a standard set of generally accepted accounting principles allows for the comparison of financial performance and condition across companies.

Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of authoritative bodies. Currently, the **Financial Accounting Standards Board (FASB)** is the authoritative body having the primary responsibility for developing accounting principles. The FASB publishes **Statements of Financial Accounting Standards** and **Interpretations** to these Standards.

Because generally accepted accounting principles impact how companies report and what they report, all stakeholders are interested in the setting of these principles. For example, the setting of accounting standards for stock-based compensation or stock options has been especially controversial. Even the United States Senate has been involved in the debate. Many managers opposed an initial proposal by the FASB that would record the value of such options as a reduction of profits because doing so would negatively impact their financial results. The FASB issued a revised proposal, but investors, analysts, and other stakeholders criticized manager stock options in light of the poor financial performances of many companies and the financial failures of **Enron**, **Tyco**, and **WorldCom**. As the debate continues, some companies are voluntarily treating stock options as a reduction of profits.

In this chapter and throughout this text, we emphasize accounting principles and concepts. It is through this emphasis on the “why” of accounting as well as the “how” that you will gain an understanding of the full significance of accounting. In the following paragraphs, we discuss the business entity concept and the cost concept.
Business Entity Concept

The individual business unit is the business entity for which economic data are needed. This entity could be an automobile dealer, a department store, or a grocery store. The business entity must be identified, so that the accountant can determine which economic data should be analyzed, recorded, and summarized in reports.

The business entity concept is important because it limits the economic data in the accounting system to data related directly to the activities of the business. In other words, the business is viewed as an entity separate from its owners, creditors, or other stakeholders. For example, the accountant for a business with one owner (a proprietorship) would record the activities of the business only, not the personal activities, property, or debts of the owner.

The Cost Concept

If a building is bought for $150,000, that amount should be entered into the buyer's accounting records. The seller may have been asking $170,000 for the building up to the time of the sale. The buyer may have initially offered $130,000 for the building. The building may have been assessed at $125,000 for property tax purposes. The buyer may have received an offer of $175,000 for the building the day after it was acquired. These latter amounts have no effect on the accounting records because they did not result in an exchange of the building from the seller to the buyer. The cost concept is the basis for entering the exchange price, or cost, of $150,000 into the accounting records for the building.

Continuing the illustration, the $175,000 offer received by the buyer the day after the building was acquired indicates that it was a bargain purchase at $150,000. To use $175,000 in the accounting records, however, would record an illusory or unrealized profit. If, after buying the building, the buyer accepts the offer and sells the building for $175,000, a profit of $25,000 is then realized and recorded. The new owner would record $175,000 as the cost of the building.

Using the cost concept involves two other important accounting concepts—objectivity and the unit of measure. The objectivity concept requires that the accounting records and reports be based upon objective evidence. In exchanges between a buyer and a seller, both try to get the best price. Only the final agreed-upon amount is objective enough for accounting purposes. If the amounts at which properties were recorded were constantly being revised upward and downward based on offers, appraisals, and opinions, accounting reports could soon become unstable and unreliable.

The unit of measure concept requires that economic data be recorded in dollars. Money is a common unit of measurement for reporting uniform financial data and reports.

Assets, Liabilities, and Owner’s Equity

The resources owned by a business are its assets. Examples of assets include cash, land, buildings, and equipment. The rights or claims to the properties are normally divided into two principal types: (1) the rights of creditors and (2) the rights of owners. The rights of creditors represent debts of the business and are called liabilities. The rights of the owners are called owner’s equity. The relationship between the two may be stated in the form of an equation, as follows:

\[ \text{Assets} = \text{Liabilities} + \text{Owner's Equity} \]

This equation is known as the accounting equation. It is usual to place liabilities before owner's equity in the accounting equation because creditors have first
If a company’s assets increase by $20,000 and its liabilities decrease by $5,000, how much did the owner’s equity increase or decrease?

\[
\begin{array}{ccc}
\text{Change in Assets} & = & \text{Change in Liabilities} + \text{Change in Owner’s Equity} \\
+$20,000 & = & -$5,000 + X \\
+$25,000 & = & X
\end{array}
\]

If a company’s rights to the assets are sometimes given greater emphasis by transposing liabilities to the other side of the equation, which yields:

\[
\text{Assets} - \text{Liabilities} = \text{Owner’s Equity}
\]

To illustrate, if the assets owned by a business amount to $100,000 and the liabilities amount to $30,000, the owner’s equity is equal to $70,000, as shown below.

\[
\begin{array}{ccc}
\text{Assets} & - & \text{Liabilities} = \text{Owner’s Equity} \\
$100,000 & - & $30,000 & = & $70,000
\end{array}
\]

**FINANCIAL REPORTING AND DISCLOSURE**

The accounting equation provides a basic framework for recording the effects of transactions on companies of all sizes and types. This basic framework serves as the foundation for accounting systems from the smallest business, such as a local convenience store, to the largest businesses. Some examples taken from recent financial reports of well-known companies are shown below.

<table>
<thead>
<tr>
<th>Company</th>
<th>Assets = Liabilities + Owners’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coca-Cola</td>
<td>$22,417 = $11,051 + $11,366</td>
</tr>
<tr>
<td>Circuit City</td>
<td>3,815 = 1,436 + 2,379</td>
</tr>
<tr>
<td>Dell Computer</td>
<td>13,435 = 7,813 + 5,622</td>
</tr>
<tr>
<td>eBay</td>
<td>1,182 = 168 + 1,014</td>
</tr>
<tr>
<td>Hilton Hotels</td>
<td>9,140 = 7,498 + 1,642</td>
</tr>
<tr>
<td>McDonald’s</td>
<td>22,535 = 13,047 + 9,488</td>
</tr>
<tr>
<td>Microsoft</td>
<td>59,257 = 11,968 + 47,289</td>
</tr>
<tr>
<td>Southwest Airlines</td>
<td>8,997 = 4,983 + 4,014</td>
</tr>
<tr>
<td>Wal-Mart</td>
<td>78,130 = 46,787 + 31,343</td>
</tr>
</tbody>
</table>

*Amounts are shown in millions of dollars.

**Business Transactions and the Accounting Equation**

Paying a monthly telephone bill of $168 affects a business’s financial condition because it now has less cash on hand. Such an economic event or condition that directly changes an entity’s financial condition or directly affects its results of operations is a **business transaction**. For example, purchasing land for $50,000 is a business transaction. In contrast, a change in a business’s credit rating does not directly affect cash or any other element of its financial condition.

All business transactions can be stated in terms of changes in the elements of the accounting equation. You will see how business transactions affect the accounting equation by studying some typical transactions. As a basis for illustration, we will use a business organized by Chris Clark.

Assume that on November 1, 2005, Chris Clark begins a business that will be known as NetSolutions. The first phase of Chris’s business plan is to operate Net-
Solutions as a service business that provides assistance to individuals and small businesses in developing Web pages and in configuring and installing application software. Chris expects this initial phase of the business to last one to two years. During this period, Chris will gather information on the software and hardware needs of customers. During the second phase of the business plan, Chris plans to expand NetSolutions into a personalized retailer of software and hardware for individuals and small businesses.

Each transaction or group of similar transactions during NetSolutions' first month of operations is described in the following paragraphs. The effect of each transaction on the accounting equation is then shown.

Transaction a  Chris Clark deposits $25,000 in a bank account in the name of NetSolutions. The effect of this transaction is to increase the asset cash (on the left side of the equation) by $25,000. To balance the equation, the owner's equity (on the right side of the equation) is increased by the same amount. The equity of the owner is referred to by using the owner's name and “Capital,” such as “Chris Clark, Capital.” The effect of this transaction on NetSolutions' accounting equation is shown below.

\[
\text{Assets} \quad = \quad \text{Owner's Equity}
\]

\[
\begin{align*}
\text{Cash} & \quad \text{Chris Clark, Capital} \\
25,000 & \quad 25,000
\end{align*}
\]

Note that since Chris Clark is the sole owner, NetSolutions is a proprietorship. Note, too, that the accounting equation shown above relates only to the business, NetSolutions. Under the business entity concept, Chris Clark's personal assets, such as a home or personal bank account, and personal liabilities are excluded from the equation.

Transaction b  If you purchased this textbook by paying cash, you entered into a transaction in which you exchanged one asset for another. That is, you exchanged cash for the textbook. Businesses often enter into similar transactions. NetSolutions, for example, exchanged $20,000 cash for land. The land is located in a new business park with convenient access to transportation facilities. Chris Clark plans to rent office space and equipment during the first phase of the business plan. During the second phase, Chris plans to build an office and warehouse on the land.

The purchase of the land changes the makeup of the assets but does not change the total assets. The items in the equation prior to this transaction and the effect of the transaction are shown next, as well as the new amounts, or balances, of the items.

\[
\begin{align*}
\text{Assets} & \quad = \quad \text{Owner's Equity} \\
\text{Cash} + \text{Van} & \quad = \quad \text{Notes Payable} \\
-8,000 + 28,000 & \quad +20,000
\end{align*}
\]

\[
\begin{align*}
\text{Assets} & \quad = \quad \text{Owner's Equity} \\
\text{Cash} + \text{Land} & \quad = \quad \text{Chris Clark, Capital} \\
25,000 & \quad 25,000
\end{align*}
\]

Transaction c  You have probably used a credit card at one time or another to buy clothing or other merchandise. In this type of transaction, you received clothing for a promise to pay your credit card bill in the future. That is, you received an asset and incurred a liability to pay a future bill. During the month, NetSolutions entered into a similar transaction, buying supplies for $1,350 and agreeing to pay the supplier in the near future. This type of transaction is called a purchase on account. The liability created is called an account payable. Items such as supplies that will be used in the business in the future are called prepaid expenses, which are assets. The effect of this transaction is to increase assets and liabilities by $1,350, as follows:
Chapter 1 • Introduction to Accounting and Business

Assets = Liabilities + Owner’s Equity

<table>
<thead>
<tr>
<th>Accounts</th>
<th>Chris Clark, Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Transaction d You may have earned money by painting houses. If so, you received money for rendering services to a customer. Likewise, a business earns money by selling goods or services to its customers. This amount is called revenue.

During its first month of operations, NetSolutions provided services to customers, earning fees of $7,500 and receiving the amount in cash. The receipt of cash increases NetSolutions’ assets and also increases Chris Clark’s equity in the business. Thus, this transaction increased cash and the owner’s equity by $7,500, as shown here.

Transaction e If you painted houses to earn money, you probably used your own ladders and brushes. NetSolutions also spent cash or used up other assets in earning revenue. The amounts used in this process of earning revenue are called expenses. Expenses include supplies used, wages of employees, and other assets and services used in operating the business.

For NetSolutions, the expenses paid during the month were as follows: wages, $2,125; rent, $800; utilities, $450; and miscellaneous, $275. Miscellaneous expenses include small amounts paid for such items as postage, coffee, and magazine subscriptions. The effect of this group of transactions is the opposite of the effect of revenues. These transactions reduce cash and owner’s equity, as shown here.
Businesses usually record each revenue and expense transaction separately as it occurs. However, to simplify this illustration, we have summarized NetSolutions’ revenues and expenses for the month in transactions (d) and (e).

Transaction f  When you pay your monthly credit card bill, you decrease the cash in your checking account and also decrease the amount you owe to the credit card company. Likewise, when NetSolutions pays $950 to creditors during the month, it reduces both assets and liabilities, as shown below.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities +</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts</td>
<td>Chris Clark,</td>
</tr>
<tr>
<td>Bal.</td>
<td>Payable</td>
<td>Capital</td>
</tr>
<tr>
<td>-950</td>
<td>-950</td>
<td>Bal. 28,850</td>
</tr>
</tbody>
</table>

You should note that paying an amount on account is different from paying an amount for an expense. The payment of an expense reduces owner’s equity, as illustrated in transaction (e). Paying an amount on account reduces the amount owed on a liability.

Transaction g  At the end of the month, the cost of the supplies on hand (not yet used) is $550. The remainder of the supplies ($1,350 - $550) was used in the operations of the business and is treated as an expense. This decrease of $800 in supplies and owner’s equity is shown as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities +</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts</td>
<td>Chris Clark,</td>
</tr>
<tr>
<td>Bal.</td>
<td>Payable</td>
<td>Capital</td>
</tr>
<tr>
<td>550</td>
<td>-800</td>
<td>Bal. 28,050</td>
</tr>
<tr>
<td></td>
<td>Supplies expense</td>
<td>-800</td>
</tr>
</tbody>
</table>

Transaction h  At the end of the month, Chris Clark withdraws $2,000 in cash from the business for personal use. This transaction is the exact opposite of an investment in the business by the owner. Cash and owner’s equity are decreased. The cash payment is not a business expense but a withdrawal of a part of the owner’s equity. The effect of the $2,000 withdrawal is shown as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities +</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts</td>
<td>Chris Clark,</td>
</tr>
<tr>
<td>Bal.</td>
<td>Payable</td>
<td>Capital</td>
</tr>
<tr>
<td>550</td>
<td>-2,000</td>
<td>Bal. 26,050</td>
</tr>
<tr>
<td></td>
<td>Withdrawal</td>
<td>-2,000</td>
</tr>
</tbody>
</table>

You should be careful not to confuse withdrawals by the owner with expenses. Withdrawals do not represent assets or services used in the process of earning revenues. The owner’s equity decrease from the withdrawals is listed in the equation under Capital. This is because withdrawals are considered a distribution of capital to the owner.

Summary  The transactions of NetSolutions are summarized as follows. They are identified by letter, and the balance of each item is shown after each transaction.
In reviewing the preceding summary, you should note the following, which apply to all types of businesses:

1. The effect of every transaction is an increase or a decrease in one or more of the accounting equation elements.
2. The two sides of the accounting equation are always equal.
3. The owner’s equity is increased by amounts invested by the owner and is decreased by withdrawals by the owner. In addition, the owner’s equity is increased by revenues and is decreased by expenses. The effects of these four types of transactions on owner’s equity are illustrated in Exhibit 5.

### Exhibit 5 Effects of Transactions on Owner’s Equity

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash +25,000</td>
<td>Accounts Payable</td>
<td></td>
</tr>
<tr>
<td>Supplies +20,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>5,000 +25,000</td>
<td>Chris Clark,</td>
</tr>
<tr>
<td>a.</td>
<td></td>
<td>Capital +25,000</td>
</tr>
<tr>
<td>Bal.</td>
<td></td>
<td>Investment by</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Chris Clark</td>
</tr>
<tr>
<td>b. -20,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal. 5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. +7,500</td>
<td></td>
<td>+7,500 Fees earned</td>
</tr>
<tr>
<td>Bal. 12,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. -3,650</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal. 8,850</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. -950</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal. 7,900</td>
<td></td>
<td></td>
</tr>
<tr>
<td>f. -800</td>
<td></td>
<td>-800 Supplies expense</td>
</tr>
<tr>
<td>Bal. 7,900</td>
<td></td>
<td></td>
</tr>
<tr>
<td>g. -2,000</td>
<td></td>
<td>-2,000 Withdrawal</td>
</tr>
<tr>
<td>Bal. 5,900</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
When you buy something at a store, you may match the cash register total with the amount you paid the cashier and with the amount of change, if any, you received.

Financial Statements

**objective 8**
Describe the financial statements of a proprietorship and explain how they interrelate.

After transactions have been recorded and summarized, reports are prepared for users. The accounting reports that provide this information are called **financial statements**. The principal financial statements of a proprietorship are the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. The order in which the statements are normally prepared and the nature of the data presented in each statement are as follows:

- **Income statement**—A summary of the revenue and expenses for a specific period of time, such as a month or a year.
- **Statement of owner's equity**—A summary of the changes in the owner's equity that have occurred during a specific period of time, such as a month or a year.
- **Balance sheet**—A list of the assets, liabilities, and owner's equity as of a specific date, usually at the close of the last day of a month or a year.
- **Statement of cash flows**—A summary of the cash receipts and cash payments for a specific period of time, such as a month or a year.

The basic features of the four statements and their interrelationships are illustrated in Exhibit 6. The data for the statements were taken from the summary of transactions of NetSolutions.

All financial statements should be identified by the name of the business, the title of the statement, and the date or period of time. The data presented in the income statement, the statement of owner's equity, and the statement of cash flows are for a period of time. The data presented in the balance sheet are for a specific date.

You should note the use of indents, captions, dollar signs, and rulings in the financial statements. They aid the reader by emphasizing the sections of the statements.

**Income Statement**

The income statement reports the revenues and expenses for a period of time, based on the **matching concept**. This concept is applied by matching the expenses with the revenue generated during a period by those expenses. The income statement also reports the excess of the revenue over the expenses incurred. This excess of the revenue over the expenses is called **net income** or **net profit**. If the expenses exceed the revenue, the excess is a **net loss**.

The effects of revenue earned and expenses incurred during the month for NetSolutions were shown in the equation as increases and decreases in owner's equity (capital). Net income for a period has the effect of increasing owner's equity (capital) for the period, whereas a net loss has the effect of decreasing owner's equity (capital) for the period.

The revenue, expenses, and the net income of $3,050 for NetSolutions are reported in the income statement in Exhibit 6. The order in which the expenses are listed in the income statement varies among businesses. One method is to list them in order of size, beginning with the larger items. Miscellaneous expense is usually shown as the last item, regardless of the amount.

**Statement of Owner’s Equity**

The statement of owner’s equity reports the changes in the owner’s equity for a period of time. It is prepared after the income statement because the net income or net loss for the period must be reported in this statement. Similarly, it is prepared before the balance sheet, since the amount of owner’s equity at the end of the period must be reported on the balance sheet. Because of this, the statement of owner’s equity is often viewed as the connecting link between the income statement and balance sheet.
### NetSolutions Income Statement
**For the Month Ended November 30, 2005**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees earned</td>
<td>$750,000</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Wages expense</td>
<td>$212,500</td>
</tr>
<tr>
<td>Rent expense</td>
<td>80,000</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>8,000</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>4,500</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>2,750</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>245,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$305,000</td>
</tr>
</tbody>
</table>

### NetSolutions Statement of Owner’s Equity
**For the Month Ended November 30, 2005**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chris Clark, capital, November 1, 2005</td>
<td>$0</td>
</tr>
<tr>
<td>Investment on November 1, 2005</td>
<td>$250,000</td>
</tr>
<tr>
<td>Net income for November</td>
<td>305,000</td>
</tr>
<tr>
<td>Less withdrawals</td>
<td>20,000</td>
</tr>
<tr>
<td>Increase in owner’s equity</td>
<td>260,500</td>
</tr>
<tr>
<td>Chris Clark, capital, November 30, 2005</td>
<td>$260,500</td>
</tr>
</tbody>
</table>

### NetSolutions Balance Sheet
**November 30, 2005**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$59,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>5,500</td>
</tr>
<tr>
<td>Land</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$264,500</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$40,000</td>
</tr>
<tr>
<td>Owner's Equity</td>
<td></td>
</tr>
<tr>
<td>Chris Clark, capital</td>
<td>260,500</td>
</tr>
<tr>
<td><strong>Total liabilities and owner's equity</strong></td>
<td>$264,500</td>
</tr>
</tbody>
</table>

### NetSolutions Statement of Cash Flows
**For the Month Ended November 30, 2005**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers</td>
<td>$75,000</td>
</tr>
<tr>
<td>Deduct cash payments for expenses and payments to creditors</td>
<td>46,000</td>
</tr>
<tr>
<td><strong>Net cash flow from operating activities</strong></td>
<td>$29,000</td>
</tr>
<tr>
<td>Cash flows from investing activities:</td>
<td></td>
</tr>
<tr>
<td>Cash payments for acquisition of land</td>
<td></td>
</tr>
<tr>
<td>Cash flows from financing activities:</td>
<td></td>
</tr>
<tr>
<td>Cash received as owner’s investment</td>
<td>$250,000</td>
</tr>
<tr>
<td>Deduct cash withdrawal by owner</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Net cash flow from financing activities</strong></td>
<td>23,000</td>
</tr>
<tr>
<td>Net cash flow and November 30, 2005 cash balance</td>
<td>$59,000</td>
</tr>
</tbody>
</table>
Three types of transactions affected owner’s equity for NetSolutions during November: (1) the original investment of $25,000, (2) the revenue and expenses that resulted in net income of $3,050 for the month, and (3) a withdrawal of $2,000 by the owner. This information is summarized in the statement of owner’s equity in Exhibit 6.

**Balance Sheet**

The balance sheet in Exhibit 6 reports the amounts of NetSolutions’ assets, liabilities, and owner’s equity at the end of November. These amounts are taken from the last line of the summary of transactions presented earlier. The form of balance sheet shown in Exhibit 6 is called the *account form* because it resembles the basic format of the accounting equation, with assets on the left side and the liabilities and owner’s equity sections on the right side. We illustrate an alternative form of balance sheet called the *report form* in a later chapter. It presents the liabilities and owner’s equity sections below the assets section.

The assets section of the balance sheet normally presents assets in the order that they will be converted into cash or used in operations. Cash is presented first, followed by receivables, supplies, prepaid insurance, and other assets. The assets of a more permanent nature are shown next, such as land, buildings, and equipment.

In the liabilities section of the balance sheet in Exhibit 6, accounts payable is the only liability. When there are two or more categories of liabilities, each should be listed and the total amount of liabilities presented as follows.

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$12,900</td>
</tr>
<tr>
<td>Wages payable</td>
<td>2,570</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td><strong>$15,470</strong></td>
</tr>
</tbody>
</table>

**Statement of Cash Flows**

The statement of cash flows consists of three sections, as we see in Exhibit 6: (1) operating activities, (2) investing activities, and (3) financing activities. Each of these sections is briefly described below.

**Cash Flows from Operating Activities**

This section reports a summary of cash receipts and cash payments from operations. The net cash flow from operating activities ($2,900 in Exhibit 6) will normally differ from the amount of net income for the period ($3,050 in Exhibit 6). This difference occurs because revenues and expenses may not be recorded at the same time that cash is received from customers or paid to creditors.

**Cash Flows from Investing Activities**

This section reports the cash transactions for the acquisition and sale of relatively permanent assets.

**Cash Flows from Financing Activities**

This section reports the cash transactions related to cash investments by the owner, borrowings, and cash withdrawals by the owner.

Preparing the statement of cash flows requires an understanding of concepts that we have not discussed in this chapter. Therefore, we will illustrate the preparation of the statement of cash flows in a later chapter.
Financial Analysis and Interpretation

Objective 9

Use the ratio of liabilities to owner’s equity to analyze the ability of a business to withstand poor business conditions.

As we discussed earlier in this chapter, financial statements are useful to bankers, creditors, owners, and other stakeholders in analyzing and interpreting the financial performance and condition of a business. Throughout this text, we will discuss various tools that are often used in practice to analyze and interpret the financial performance and condition of a business. The first such tool we will introduce is especially useful in analyzing the ability of a business to pay its creditors.

The relationship between liabilities and owner’s equity, expressed as a ratio, is calculated as follows:

\[
\text{Ratio of liabilities to owner’s equity} = \frac{\text{Total liabilities}}{\text{Total owner’s equity (or Total stockholders’ equity)}}
\]

To illustrate, NetSolutions’ ratio of liabilities to owner’s equity at the end of November is 0.015, as calculated below.

\[
\text{Ratio of liabilities to owner’s equity} = \frac{400}{26,050} = 0.015
\]

Corporations normally refer to total owner’s equity as total stockholders’ equity. Thus, you should substitute total stockholders’ equity for total owner’s equity when computing this ratio for a corporation.

The rights of creditors to a business’s assets take precedence over the rights of the owners or stockholders. Thus, the lower the ratio of liabilities to owner’s equity, the better able the business is to withstand poor business conditions and still fully meet its obligations to creditors.

To illustrate, a ratio of 1 indicates that the liabilities and owner’s equity are equal. In other words, if the business suffers a loss equal to the total liabilities, the amount of total assets available to creditors will not drop below their claims on the assets. If this were to happen, the creditors could collect their claims and the owner would be left with nothing.

Spotlight on Strategy

It’s All in the Name

Intel develops and produces microprocessors for use in electronic equipment, including personal computers and organizers. Beginning with the 8086 processor and continuing with the 286, 386, and 486 processors, Intel’s processors were widely used in personal computers during the 1980s and 1990s. Intel’s competitors, however, also developed and sold 386 and 486 processors. In doing so, its competitors were able to erode Intel’s market share. In responding, Intel named its next microprocessor the “Pentium,” rather than the 586, and registered “Pentium” as a trademark. By doing so, Intel prevented its competitors from selling their products as “Pentiums.” Thus, Intel developed a “differentiated” brand name that its competitors were unable to duplicate. Intel’s newest processor is called the “Pentium M.”
1 **Describe the nature of a business.**

A business is an organization in which basic resources (inputs), such as materials and labor, are assembled and processed to provide goods or services (outputs) to customers. The objective of most businesses is to maximize profits.

There are three different types of businesses that are operated for profit: manufacturing, merchandising, and service businesses. A business is normally organized in one of the following forms: proprietorship, partnership, corporation, or limited liability corporation. A business stakeholder is a person or entity (such as an owner, manager, employee, customer, creditor, or the government) who has an interest in the economic performance of the business.

2 **Describe the role of accounting in business.**

Accounting is an information system that provides reports to stakeholders about the economic activities and condition of a business. Accounting is the “language of business.”

3 **Describe the importance of business ethics and the basic principles of proper ethical conduct.**

Ethics are moral principles that guide the conduct of individuals. Proper ethical conduct implies a behavior that considers the impact of one’s actions on society and others. Sound ethical principles include (1) avoiding small ethical lapses, (2) focusing on your long-term reputation, and (3) being willing to suffer adverse personal consequences for holding to an ethical position.

4 **Describe the profession of accounting.**

Accountants are engaged in either private accounting or public accounting. The two most common specialized fields of accounting are financial accounting and managerial accounting. Other fields include cost accounting, environmental accounting, tax accounting, accounting systems, international accounting, not-for-profit accounting, and social accounting.

5 **Summarize the development of accounting principles and relate them to practice.**

Financial accountants follow generally accepted accounting principles (GAAP) in preparing reports so that stakeholders can compare one company to another. Accounting principles and concepts develop from research, accepted accounting practices, and pronouncements of authoritative bodies. Currently, the Financial Accounting Standards Board (FASB) is the authoritative body having the primary responsibility for developing accounting principles.

The business entity concept views the business as an entity separate from its owners, creditors, or other stakeholders. The business entity limits the economic data in the accounting system to that related directly to the activities of the business. The cost concept requires that properties and services bought by a business be recorded in terms of actual cost. The objectivity concept requires that the accounting records and reports be based upon objective evidence. The unit of measure concept requires that economic data be recorded in dollars.

6 **State the accounting equation and define each element of the equation.**

The resources owned by a business and the rights or claims to these resources may be stated in the form of an equation, as follows:

\[
\text{Assets} = \text{Liabilities} + \text{Owner's Equity}
\]

7 **Explain how business transactions can be stated in terms of the resulting changes in the basic elements of the accounting equation.**

All business transactions can be stated in terms of the change in one or more of the three elements of the accounting equation. That is, the effect of every transaction can be stated in terms of increases or decreases in one or more of these elements, while maintaining the equality between the two sides of the equation.

8 **Describe the financial statements of a proprietorship and explain how they interrelate.**

The principal financial statements of a proprietorship are the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. The income statement reports a period's net income or net loss, which also appears on the statement of owner's equity. The ending owner's capital reported on the statement of owner's equity is also reported on the balance sheet. The ending cash balance is reported on the balance sheet and the statement of cash flows.

9 **Use the ratio of liabilities to owner's equity to analyze the ability of a business to withstand poor business conditions.**

The ratio of liabilities to owner's equity is useful in analyzing the ability of a business to pay its creditors. The lower the ratio, the better able the business is to withstand poor business conditions and still fully meet its obligations to creditors.
Illustrative Problem

Cecil Jameson, Attorney-at-Law, is a proprietorship owned and operated by Cecil Jameson. On July 1, 2005, Cecil Jameson, Attorney-at-Law, has the following assets and liabilities: cash, $1,000; accounts receivable, $3,200; supplies, $850; land, $10,000; accounts payable, $1,530. Office space and office equipment are currently being rented, pending the construction of an office complex on land purchased last year. Business transactions during July are summarized as follows:

a. Received cash from clients for services, $3,928.
b. Paid creditors on account, $1,055.
c. Received cash from Cecil Jameson as an additional investment, $3,700.
d. Paid office rent for the month, $1,200.
e. Charged clients for legal services on account, $2,025.
f. Purchased office supplies on account, $245.
g. Received cash from clients on account, $3,000.
h. Received invoice for paralegal services from Legal Aid Inc. for July (to be paid on August 10), $1,635.
i. Paid the following: wages expense, $850; answering service expense, $250; utilities expense, $325; and miscellaneous expense, $75.
j. Determined that the cost of office supplies on hand was $980; therefore, the cost of supplies used during the month was $115.
k. Jameson withdrew $1,000 in cash from the business for personal use.

Instructions

1. Determine the amount of owner’s equity (Cecil Jameson’s capital) as of July 1, 2005.
2. State the assets, liabilities, and owner’s equity as of July 1 in equation form similar to that shown in this chapter. In tabular form below the equation, indicate the increases and decreases resulting from each transaction and the new balances after each transaction. Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.

**Solution**

1. **Assets – Liabilities = Owner’s Equity (Cecil Jameson, capital)**

   \[ $15,050 - $1,530 = \text{Owner's Equity (Cecil Jameson, capital)} \]

   \[ $13,520 = \text{Owner's Equity (Cecil Jameson, capital)} \]

2. **Assets = Liabilities + Owner’s Equity**

<table>
<thead>
<tr>
<th>Accounts</th>
<th>+</th>
<th>Accounts</th>
<th>=</th>
<th>Owners Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bal.</td>
<td></td>
<td>Cash</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>a.</td>
<td>+3,928</td>
<td>Receivable</td>
<td>3,200</td>
<td>+</td>
</tr>
<tr>
<td>b.</td>
<td>-1,055</td>
<td>Supplies</td>
<td>850</td>
<td></td>
</tr>
<tr>
<td>c.</td>
<td>+3,700</td>
<td>Land</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>d.</td>
<td>-1,200</td>
<td>Payable</td>
<td>1,530</td>
<td></td>
</tr>
<tr>
<td>e.</td>
<td>+2,025</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>f.</td>
<td>+245</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>g.</td>
<td>+3,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h.</td>
<td>+1,635</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i.</td>
<td>-1,500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>j.</td>
<td>-115</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>k.</td>
<td>-1,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>6,873</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3. **Cecil Jameson, Attorney-at-Law**

   **Income Statement**
   
   For the Month Ended July 31, 2005

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees earned</td>
<td>$9,353.00</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Paralegal expense</td>
<td>$1,635.00</td>
</tr>
<tr>
<td>Rent expense</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>Wages expense</td>
<td>$8,500.00</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>$3,250.00</td>
</tr>
<tr>
<td>Answering service expense</td>
<td>$2,500.00</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>$1,150.00</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>$750.00</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>$44,500.00</td>
</tr>
<tr>
<td>Net income</td>
<td>$15,030.00</td>
</tr>
</tbody>
</table>
Chapter 1 • Introduction to Accounting and Business

Self-Examination Questions  (Answers at End of Chapter)

1. A profit-making business operating as a separate legal entity and in which ownership is divided into shares of stock is known as a:
   A. proprietorship.  C. partnership.

2. The resources owned by a business are called:
   A. assets.  B. liabilities.
   C. the accounting equation.  D. owner’s equity.

3. A listing of a business entity’s assets, liabilities, and owner’s equity as of a specific date is:
   A. a balance sheet.  B. an income statement.
   C. a statement of owner’s equity.  D. a statement of cash flows.

4. If total assets increased $20,000 during a period and total liabilities increased $12,000 during the same period, the amount and direction (increase or decrease) of the change in owner’s equity for that period is:
   A. a $32,000 increase.  C. an $8,000 increase.
   B. a $32,000 decrease.  D. an $8,000 decrease.

5. If revenue was $45,000, expenses were $37,500, and the owner’s withdrawals were $10,000, the amount of net income or net loss would be:
   A. $45,000 net income.  C. $37,500 net loss.
   B. $7,500 net income.  D. $2,500 net loss.
Class Discussion Questions

1. What is the objective of most businesses?
2. What is the difference between a manufacturing business and a service business? Is a restaurant a manufacturing business, a service business, or both?
3. Why are most large companies like Microsoft, Pepsi, Caterpillar, and AutoZone organized as corporations?
4. Both KIA and Porche produce and sell automobiles. Describe and contrast the business strategies of KIA and Porche.
5. Assume that a friend of yours operates a family-owned pharmacy. A Super Wal-Mart is scheduled to open in the next several months that will also offer pharmacy services. What business strategy would your friend use to compete with the Super Wal-Mart pharmacy?
6. How does eBay offer value to its customers?
7. Who are normally included as the stakeholders of a business?
8. What is the role of accounting in business?
9. Deana Moran is the owner of First Delivery Service. Recently, Deana paid interest of $3,600 on a personal loan of $60,000 that she used to begin the business. Should First Delivery Service record the interest payment? Explain.
10. On July 10, Elrod Repair Service extended an offer of $100,000 for land that had been priced for sale at $120,000. On July 25, Elrod Repair Service accepted the seller's counteroffer of $112,000. Describe how Elrod Repair Service should record the land.
11. a. Land with an assessed value of $300,000 for property tax purposes is acquired by a business for $500,000. Seven years later, the plot of land has an assessed value of $400,000 and the business receives an offer of $600,000 for it. Should the monetary amount assigned to the land in the business records now be increased?
   b. Assuming that the land acquired in (a) was sold for $600,000, how would the various elements of the accounting equation be affected?
12. Describe the difference between an account receivable and an account payable.
13. A business had revenues of $280,000 and operating expenses of $315,000. Did the business (a) incur a net loss or (b) realize net income?
14. A business had revenues of $750,000 and operating expenses of $670,000. Did the business (a) incur a net loss or (b) realize net income?
15. What particular item of financial or operating data appears on both the income statement and the statement of owner's equity? What item appears on both the balance sheet and the statement of owner's equity? What item appears on both the balance sheet and statement of cash flows?
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Answer: McDonald’s

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- You will get immediate feedback to determine if you have done the problems correctly.

### Study Guide

Chapters 1-17 0-324-20373-X
Chapters 12-25 0-324-20374-8

- This guide will give you quiz and test hints.
- You can practice chapter concepts, learn through numerous multiple choice, fill-in-the-blank, true-false questions, and exercises, and check your answers against the provided solutions.

### Working Papers for Exercises and Problems

Chapters 1-17 0-324-20375-6
Chapters 12-25 0-324-20376-4

This supplement contains forms that help you organize your solutions.

### Working Papers Plus for Selected Exercises and Problems

Chapters 1-17 0-324-23077-2
Chapters 12-25 0-324-20378-0

This supplement includes selected exercises and problems from the text, along with the forms for your use in solving them.
**Exercises**

**EXERCISE 1-1**

*Types of businesses*

**Objective 1**

Indicate whether each of the following companies is primarily a service, merchandise, or manufacturing business. If you are unfamiliar with the company, you may use the Internet to locate the company’s home page or use the finance Web site of Yahoo.com.

1. Ford Motor
2. Citigroup
3. Sears Roebuck
4. AT&T
5. H&R Block Inc.
6. Boeing
7. First Union Corporation
8. Alcoa
9. CVS
10. Caterpillar
11. FedEx
12. Dow Chemical
13. Gap
14. Hilton Hotels
15. Procter & Gamble

**EXERCISE 1-2**

*Business strategy*

**Objective 1**

Identify the primary business strategy of each of the following companies as (a) a low-cost strategy, (b) a differentiation strategy, or (c) a combination strategy. If you are unfamiliar with the company, you may use the Internet to locate the company’s home page or use the finance Web site of Yahoo.com.

1. Southwest Airlines
2. Home Depot
3. BMW
4. Coca-Cola
5. Target
6. Goldman Sachs Group
7. Sara Lee
8. Delta Air Lines
9. Circuit City Stores
10. Maytag
11. Office Depot
12. Nike
13. Charles Schwab
14. Dollar General
15. General Motors

**EXERCISE 1-3**

*Professional ethics*

**Objective 3**

A fertilizer manufacturing company wants to relocate to Collier County. A 13-year-old report from a fired researcher at the company says the company’s product is releasing toxic by-products. The company has suppressed that report. A second report commissioned by the company shows there is no problem with the fertilizer.

Should the company’s chief executive officer reveal the context of the unfavorable report in discussions with Collier County representatives? Discuss.

**EXERCISE 1-4**

*Business entity concept*

**Objective 5**

Bechler Sports sells hunting and fishing equipment and provides guided hunting and fishing trips. Bechler Sports is owned and operated by Lefty Wisman, a well-known sports enthusiast and hunter. Lefty’s wife, Betsy, owns and operates Eagle Boutique, a women’s clothing store. Lefty and Betsy have established a trust fund to finance their children’s college education. The trust fund is maintained by First Montana Bank in the name of the children, Jeff and Steph.

For each of the following transactions, identify which of the entities listed should record the transaction in its records.

<table>
<thead>
<tr>
<th>Entities</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Bechler Sports</td>
</tr>
<tr>
<td>F</td>
<td>First Montana Bank</td>
</tr>
<tr>
<td>E</td>
<td>Eagle Boutique</td>
</tr>
<tr>
<td>X</td>
<td>None of the above</td>
</tr>
</tbody>
</table>

1. Lefty paid a local doctor for his annual physical, which was required by the workmen’s compensation insurance policy carried by Bechler Sports.

(continued)
2. Lefty received a cash advance from customers for a guided hunting trip.
3. Betsy purchased two dozen spring dresses from a Billings (MT) designer for a special spring sale.
4. Betsy deposited a $2,000 personal check in the trust fund at First Montana Bank.
5. Lefty paid for an advertisement in a hunters’ magazine.
6. Betsy purchased mutual fund shares as an investment for the children’s trust.
7. Lefty paid for dinner and a movie to celebrate their twentieth wedding anniversary.
8. Betsy donated several dresses from inventory for a local charity auction for the benefit of a women’s abuse shelter.
9. Betsy paid her dues to the YWCA.
10. Lefty paid a breeder’s fee for an English springer spaniel to be used as a hunting guide dog.

The total assets and total liabilities of Coca-Cola and PepsiCo are shown below.

<table>
<thead>
<tr>
<th></th>
<th>Coca-Cola (in millions)</th>
<th>PepsiCo (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$24,501</td>
<td>$23,474</td>
</tr>
<tr>
<td>Liabilities</td>
<td>12,701</td>
<td>14,183</td>
</tr>
</tbody>
</table>

Determine the owners’ equity of each company.

The total assets and total liabilities of Toys “R” Us Inc. and Estée Lauder Companies Inc. are shown below.

<table>
<thead>
<tr>
<th></th>
<th>Toys “R” Us (in millions)</th>
<th>Estée Lauder Companies (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$9,397</td>
<td>$3,417</td>
</tr>
<tr>
<td>Liabilities</td>
<td>5,367</td>
<td>1,955</td>
</tr>
</tbody>
</table>

Determine the owners’ equity of each company.

Determine the missing amount for each of the following:

\[
\text{Assets} = \text{Liabilities} + \text{Owner’s Equity}
\]

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>X</td>
<td>$25,000   +</td>
</tr>
<tr>
<td>b.</td>
<td>$82,750 = X + 15,000</td>
<td></td>
</tr>
<tr>
<td>c.</td>
<td>37,000 = 17,500 + X</td>
<td></td>
</tr>
</tbody>
</table>

Chris Lund is the owner and operator of Saluki, a motivational consulting business. At the end of its accounting period, December 31, 2005, Saluki has assets of $475,000 and liabilities of $200,000. Using the accounting equation and considering each case independently, determine the following amounts:


b. Chris Lund, capital, as of December 31, 2006, assuming that assets increased by $75,000 and liabilities increased by $40,000 during 2006.

c. Chris Lund, capital, as of December 31, 2006, assuming that assets decreased by $15,000 and liabilities increased by $27,000 during 2006.

d. Chris Lund, capital, as of December 31, 2006, assuming that assets increased by $125,000 and liabilities decreased by $65,000 during 2006.

e. Net income (or net loss) during 2006, assuming that as of December 31, 2006, assets were $425,000, liabilities were $105,000, and there were no additional investments or withdrawals.
Indicate whether each of the following is identified with (1) an asset, (2) a liability, or (3) owner's equity:

a. wages expense  
b. accounts payable  
c. cash  
d. land  
e. fees earned  
f. supplies

Describe how the following business transactions affect the three elements of the accounting equation.

a. Received cash for services performed.
b. Invested cash in business.
c. Paid for utilities used in the business.
d. Purchased supplies on account.
e. Purchased supplies for cash.

a. A vacant lot acquired for $50,000 is sold for $130,000 in cash. What is the effect of the sale on the total amount of the seller’s (1) assets, (2) liabilities, and (3) owner’s equity?
b. Assume that the seller owes $30,000 on a loan for the land. After receiving the $130,000 cash in (a), the seller pays the $30,000 owed. What is the effect of the payment on the total amount of the seller's (1) assets, (2) liabilities, and (3) owner's equity?

Indicate whether each of the following types of transactions will (a) increase owner's equity or (b) decrease owner's equity:

1. revenues  
2. expenses  
3. owner's investments  
4. owner's withdrawals

The following selected transactions were completed by Salvo Delivery Service during February:

1. Received cash from owner as additional investment, $35,000.
2. Received cash for providing delivery services, $15,000.
3. Paid creditors on account, $1,800.
4. Billed customers for delivery services on account, $11,250.
5. Paid advertising expense, $750.
6. Purchased supplies for cash, $800.
7. Paid rent for February, $2,000.
8. Received cash from customers on account, $6,740.
9. Determined that the cost of supplies on hand was $135; therefore, $665 of supplies had been used during the month.
10. Paid cash to owner for personal use, $1,000.

Indicate the effect of each transaction on the accounting equation by listing the numbers identifying the transactions, (1) through (10), in a vertical column, and inserting at the right of each number the appropriate letter from the following list:

a. Increase in an asset, decrease in another asset.
b. Increase in an asset, increase in a liability.
c. Increase in an asset, increase in owner's equity.
d. Decrease in an asset, decrease in a liability.
e. Decrease in an asset, decrease in owner's equity.

Mike Renner operates his own catering service. Summary financial data for March are presented in equation form as follows. Each line designated by a number indicates the effect of a transaction on the equation. Each increase and decrease in owner's equity, except transaction (5), affects net income.
Chapter 1 • Introduction to Accounting and Business

Exercise 1-15

Net income and owner’s withdrawals
Objective 8

Exercise 1-16

Net income and owner’s equity for four businesses
Objective 8
✓ Company O: Net loss, ($50,000)

Exercise 1-17

Balance sheet items
Objective 8

Exercise 1-18

Income statement items
Objective 8

From the following list of selected items taken from the records of Ishmael Appliance Service as of a specific date, identify those that would appear on the balance sheet:

1. Supplies 6. Fees Earned
2. Wages Expense 7. Supplies Expense
3. Cash 8. Accounts Payable
4. Land 9. Melinda Elder, Capital
5. Utilities Expense 10. Wages Payable

Based on the data presented in Exercise 1-17, identify those items that would appear on the income statement.
Financial information related to Madras Company, a proprietorship, for the month ended April 30, 2006, is as follows:

- Net income for April: $73,000
- Leo Perkins’s withdrawals during April: $12,000
- Leo Perkins, capital, April 1, 2006: $297,200

Prepare a statement of owner’s equity for the month ended April 30, 2006.

Hercules Services was organized on November 1, 2006. A summary of the revenue and expense transactions for November follows:

- Fees earned: $232,120
- Wages expense: $100,100
- Miscellaneous expense: $3,150
- Rent expense: $35,000
- Supplies expense: $4,550

Prepare an income statement for the month ended November 30.

One item is omitted in each of the following summaries of balance sheet and income statement data for four different proprietorships, A, B, C, and D.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$720,000</td>
<td>$125,000</td>
<td>$160,000</td>
<td>(d)</td>
</tr>
<tr>
<td>Liabilities</td>
<td>432,000</td>
<td>65,000</td>
<td>121,600</td>
<td>$150,000</td>
</tr>
<tr>
<td>Assets</td>
<td>894,000</td>
<td>175,000</td>
<td>144,000</td>
<td>310,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>390,000</td>
<td>55,000</td>
<td>128,000</td>
<td>170,000</td>
</tr>
<tr>
<td>Additional investment in the business</td>
<td>(a)</td>
<td>25,000</td>
<td>16,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Withdrawals from the business</td>
<td>48,000</td>
<td>8,000</td>
<td>(c)</td>
<td>75,000</td>
</tr>
<tr>
<td>Revenue</td>
<td>237,300</td>
<td>(b)</td>
<td>184,000</td>
<td>140,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>129,600</td>
<td>32,000</td>
<td>196,000</td>
<td>160,000</td>
</tr>
</tbody>
</table>

Determine the missing amounts, identifying them by letter. (Hint: First determine the amount of increase or decrease in owner’s equity during the year.)

Financial information related to the proprietorship of Derby Interiors for October and November 2006 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>October 31, 2006</th>
<th>November 30, 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$12,320</td>
<td>$13,280</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>27,200</td>
<td>31,300</td>
</tr>
<tr>
<td>Mary Lou Reily, capital</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Cash</td>
<td>48,000</td>
<td>81,600</td>
</tr>
<tr>
<td>Supplies</td>
<td>2,400</td>
<td>2,000</td>
</tr>
</tbody>
</table>

a. Prepare balance sheets for Derby Interiors as of October 31 and as of November 30, 2006.
b. Determine the amount of net income for November, assuming that the owner made no additional investments or withdrawals during the month.
c. Determine the amount of net income for November, assuming that the owner made no additional investments but withdrew $10,000 during the month.
EXERCISE 1-23
Financial statements
Objective 8

Each of the following items is shown in the financial statements of Exxon Mobil Corporation. Identify the financial statement (balance sheet or income statement) in which each item would appear.

a. Operating expenses  
i. Cash equivalents
b. Crude oil inventory  
j. Long-term debt
c. Income taxes payable  
k. Selling expenses
d. Sales  
l. Notes receivable
e. Investments  
m. Equipment
f. Marketable securities  
n. Accounts payable
g. Exploration expenses  
o. Prepaid taxes
h. Notes and loans payable

EXERCISE 1-24
Statement of cash flows
Objective 8

Indicate whether each of the following activities would be reported on the statement of cash flows as (a) an operating activity, (b) an investing activity, or (c) a financing activity:

1. Cash paid for land  
2. Cash received from fees earned  
3. Cash received as owner’s investment  
4. Cash paid for expenses

Caddis Realty, organized June 1, 2006, is owned and operated by Jerry Maris. How many errors can you find in the following financial statements for Caddis Realty, prepared after its second month of operations?

EXERCISE 1-25
Financial statements
Objective 8

Correct Amount of Total Assets is $19,600

Caddis Realty
Income Statement
July 31, 2006

Sales commissions .......................................................... $51,900
Operating expenses:
  Office salaries expense ........................................... $32,400
  Rent expense .......................................................... 11,000
  Automobile expense ................................................. 2,500
  Miscellaneous expense ............................................. 800
  Supplies expense ..................................................... 300
  Total operating expenses ........................................... 47,000
Net income ............................................................... $14,900

Jerry Maris
Statement of Owner’s Equity
July 31, 2005

Jerry Maris, capital, July 1, 2006 ........................................ $10,400
Less withdrawals during July ......................................... 2,000
$ 8,400
Additional investment during July .................................... 2,500
$10,900
Net income for the month ............................................... 14,900
Jerry Maris, capital, July 31, 2006 ..................................... $25,800

Balance Sheet
For the Month Ended July 31, 2006

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts receivable</td>
</tr>
<tr>
<td>3,300</td>
<td>Supplies</td>
</tr>
<tr>
<td>Accounts payable</td>
<td></td>
</tr>
<tr>
<td>3,800</td>
<td>Owner’s Equity</td>
</tr>
<tr>
<td></td>
<td>Jerry Maris, capital</td>
</tr>
<tr>
<td></td>
<td>Total liabilities and owner’s equity</td>
</tr>
<tr>
<td>Total assets</td>
<td></td>
</tr>
</tbody>
</table>
The **Home Depot, Inc.**, is the world's largest home improvement retailer and one of the largest retailers in the United States based on net sales volume. The Home Depot operates over 1,100 Home Depot® stores that sell a wide assortment of building materials and home improvement and lawn and garden products. The Home Depot also operates over 25 EXPO Design Center stores that offer interior design products, such as kitchen and bathroom cabinetry, tiles, flooring, and lighting fixtures, and installation services.

For the years ending February 2, 2003, and February 3, 2002, The Home Depot reported the following balance sheet data (in millions):

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$30,011</td>
<td>$26,394</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>19,802</td>
<td>18,082</td>
</tr>
</tbody>
</table>

b. Determine the ratio of liabilities to stockholders' equity for 2003 and 2002. Round to two decimal places.
c. What conclusions regarding the margin of protection to the creditors can you draw from (b)?

**Lowe's**, a major competitor of The Home Depot in the home improvement business, operates over 700 stores. For the years ending January 31, 2003, and February 1, 2002, Lowe's reported the following balance sheet data (in millions):

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$16,109</td>
<td>$13,736</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>8,302</td>
<td>7,062</td>
</tr>
</tbody>
</table>

b. Determine the ratio of liabilities to stockholders' equity for 2003 and 2002. Round to two decimal places.
c. What conclusions regarding the margin of protection to the creditors can you draw from (b)?
d. How does the ratio of liabilities to stockholders' equity of Lowe's compare to that of The Home Depot?

---

**Problems Series A**

**PROBLEM 1-1A**

Transactions

Objective 7

Cash bal. at end of July: $16,000

Duane Mays established an insurance agency on July 1 of the current year and completed the following transactions during July:

a. Opened a business bank account with a deposit of $18,000 from personal funds.
b. Purchased supplies on account, $950.
c. Paid creditors on account, $575.
d. Received cash from fees earned on insurance commissions, $4,250.
e. Paid rent on office and equipment for the month, $1,200.
f. Paid automobile expenses for month, $600, and miscellaneous expenses, $375.
g. Paid office salaries, $1,500.
h. Determined that the cost of supplies on hand was $225; therefore, the cost of supplies used was $725.
i. Billed insurance companies for sales commissions earned, $6,350.
j. Withdrew cash for personal use, $2,000.
Instructions

1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

<table>
<thead>
<tr>
<th>Assets</th>
<th>=</th>
<th>Liabilities</th>
<th>+</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash + Accounts Receivable + Supplies = Accounts Payable + Duane Mays, Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Explain the nature of each increase and decrease in owner's equity by an appropriate notation at the right of the amount.

2. Briefly explain why the owner's investment and revenues increased owner's equity, while withdrawals and expenses decreased owner's equity.

The amounts of the assets and liabilities of Chickadee Travel Service at April 30, 2006, the end of the current year, and its revenue and expenses for the year are listed below. The capital of Adam Cellini, owner, was $50,000 at May 1, 2005, the beginning of the current year, and the owner withdrew $30,000 during the current year.

<table>
<thead>
<tr>
<th>Accounts payable</th>
<th>$ 12,200</th>
<th>Supplies</th>
<th>$ 3,350</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>31,350</td>
<td>Supplies expense</td>
<td>7,100</td>
</tr>
<tr>
<td>Cash</td>
<td>53,050</td>
<td>Taxes expense</td>
<td>5,600</td>
</tr>
<tr>
<td>Fees earned</td>
<td>263,200</td>
<td>Utilities expense</td>
<td>22,500</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>2,950</td>
<td>Wages expense</td>
<td>131,700</td>
</tr>
<tr>
<td>Rent expense</td>
<td>37,800</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Instructions


Jeanine Sykes established Linchpin Computer Services on August 1, 2006. The effect of each transaction and the balances after each transaction for August are as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>=</th>
<th>Liabilities</th>
<th>+</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts</td>
<td>Cash</td>
<td>Receivable + Supplies = Accounts Payable + Jeanine Sykes, Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a.</td>
<td>+10,000</td>
<td>+1,440</td>
<td>+1,440</td>
<td>+10,000</td>
</tr>
<tr>
<td>b.</td>
<td>+ 9,000</td>
<td>+1,440</td>
<td>+1,440</td>
<td>+ 9,000</td>
</tr>
<tr>
<td>c.</td>
<td>−3,600</td>
<td>+1,440</td>
<td>+1,440</td>
<td>−3,600</td>
</tr>
<tr>
<td>d.</td>
<td>− 500</td>
<td>+1,440</td>
<td>+1,440</td>
<td>− 500</td>
</tr>
<tr>
<td>e.</td>
<td>+7,500</td>
<td>+1,440</td>
<td>+940</td>
<td>+7,500</td>
</tr>
<tr>
<td>f.</td>
<td>+2,300</td>
<td>+1,440</td>
<td>+940</td>
<td>+2,300</td>
</tr>
<tr>
<td>g.</td>
<td>− 4,000</td>
<td>+1,440</td>
<td>+940</td>
<td>− 4,000</td>
</tr>
<tr>
<td>h.</td>
<td>−650</td>
<td>+1,440</td>
<td>+940</td>
<td>−650</td>
</tr>
<tr>
<td>i.</td>
<td>+650</td>
<td>+1,440</td>
<td>+940</td>
<td>+650</td>
</tr>
<tr>
<td>j.</td>
<td>−2,000</td>
<td>+1,440</td>
<td>+940</td>
<td>−2,000</td>
</tr>
<tr>
<td>k.</td>
<td>+6,600</td>
<td>+1,440</td>
<td>+940</td>
<td>+6,600</td>
</tr>
</tbody>
</table>

Instructions

On August 1, 2006, Shad Menard established Centillion Realty. Shad completed the following transactions during the month of August:

a. Opened a business bank account with a deposit of $15,000 from personal funds.
b. Paid rent on office and equipment for the month, $2,400.
c. Paid automobile expenses (including rental charge) for month, $750, and miscellaneous expenses, $380.
d. Purchased supplies (pens, file folders, and copy paper) on account, $950.
e. Earned sales commissions, receiving cash, $17,350.
f. Paid creditor on account, $580.
g. Paid office salaries, $3,600.
h. Withdrew cash for personal use, $1,500.
i. Determined that the cost of supplies on hand was $275; therefore, the cost of supplies used was $675.

Instructions
1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash + Supplies</td>
<td>Accounts Payable + Shad Menard, Capital</td>
</tr>
</tbody>
</table>

Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.

2. Prepare an income statement for August, a statement of owner’s equity for August, and a balance sheet as of August 31.

Eureka Dry Cleaners is owned and operated by Vince Fry. A building and equipment are currently being rented, pending expansion to new facilities. The actual work of dry cleaning is done by another company at wholesale rates. The assets and the liabilities of the business on June 1, 2006, are as follows: Cash, $8,600; Accounts Receivable, $9,500; Supplies, $1,875; Land, $15,000; Accounts Payable, $4,100. Business transactions during June are summarized as follows:

a. Paid rent for the month, $4,000.
b. Charged customers for dry cleaning sales on account, $8,150.
c. Paid creditors on account, $2,680.
d. Purchased supplies on account, $1,500.
e. Received cash from cash customers for dry cleaning sales, $17,600.
f. Received cash from customers on account, $8,450.
g. Received monthly invoice for dry cleaning expense for June (to be paid on July 10), $7,400.
h. Paid the following: wages expense, $2,800; truck expense, $825; utilities expense, $710; miscellaneous expense, $390.
i. Determined that the cost of supplies on hand was $1,600; therefore, the cost of supplies used during the month was $1,775.
j. Withdrew $3,500 for personal use.

Instructions
1. Determine the amount of Vince Fry’s capital as of June 1.
2. State the assets, liabilities, and owner’s equity as of June 1 in equation form similar to that shown in this chapter. In tabular form below the equation, indicate increases and decreases resulting from each transaction and the new balances after each transaction. Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.
3. Prepare an income statement for June, a statement of owner’s equity for June, and a balance sheet as of June 30.

The financial statements at the end of Ameba Realty’s first month of operations are shown on the next page.
### Ameba Realty

#### Income Statement
For the Month Ended June 30, 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fees earned</td>
<td>$18,800.00</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Wages expense</td>
<td>$(a)</td>
</tr>
<tr>
<td>Rent expense</td>
<td>1920.00</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>1600.00</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>1080.00</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>660.00</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>9560.00</td>
</tr>
<tr>
<td>Net income</td>
<td>(b)</td>
</tr>
</tbody>
</table>

#### Statement of Owner's Equity
For the Month Ended June 30, 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terry Garcia, capital, June 1, 2006</td>
<td>$(c)</td>
</tr>
<tr>
<td>Investment on June 1, 2006</td>
<td>$(d)</td>
</tr>
<tr>
<td>Net income for June</td>
<td>$(e)</td>
</tr>
<tr>
<td>Less withdrawals</td>
<td>(g)</td>
</tr>
<tr>
<td>Increase in owner’s equity</td>
<td>$(h)</td>
</tr>
<tr>
<td>Terry Garcia, capital, June 30, 2006</td>
<td>$(i)</td>
</tr>
</tbody>
</table>

#### Balance Sheet
June 30, 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$11,800.00</td>
</tr>
<tr>
<td>Supplies</td>
<td>800.00</td>
</tr>
<tr>
<td>Land</td>
<td>(j)</td>
</tr>
<tr>
<td>Total assets</td>
<td>(k)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$9,600.00</td>
</tr>
<tr>
<td>Owner’s Equity</td>
<td>(l)</td>
</tr>
<tr>
<td>Total liabilities and owner’s equity</td>
<td>(m)</td>
</tr>
</tbody>
</table>

### Ameba Realty

#### Statement of Cash Flows
For the Month Ended June 30, 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows from operating activities:</td>
<td>(n)</td>
</tr>
<tr>
<td>Cash received from customers</td>
<td>$</td>
</tr>
<tr>
<td>Deduct cash payments for expenses and payments to creditors</td>
<td>9400.00</td>
</tr>
<tr>
<td>Net cash flow from operating activities</td>
<td>$ (o)</td>
</tr>
<tr>
<td>Cash flows from investing activities:</td>
<td>28800.00</td>
</tr>
<tr>
<td>Cash payments for acquisition of land</td>
<td></td>
</tr>
<tr>
<td>Cash flows from financing activities:</td>
<td>(p)</td>
</tr>
<tr>
<td>Cash received as owner’s investment</td>
<td>36000.00</td>
</tr>
<tr>
<td>Deduct cash withdrawal by owner</td>
<td>4800.00</td>
</tr>
<tr>
<td>Net cash flow from financing activities</td>
<td></td>
</tr>
<tr>
<td>Net cash flow and June 30, 2006 cash balance</td>
<td>(q)</td>
</tr>
</tbody>
</table>
On September 1 of the current year, Pamela Larsen established a business to manage rental property. She completed the following transactions during September:

a. Opened a business bank account with a deposit of $15,000 from personal funds.

b. Purchased supplies (pens, file folders, and copy paper) on account, $1,350.

c. Received cash from fees earned for managing rental property, $6,500.

d. Paid rent on office and equipment for the month, $2,500.

e. Paid creditors on account, $700.

f. Billed customers for fees earned for managing rental property, $1,250.

g. Paid automobile expenses (including rental charges) for month, $550, and miscellaneous expenses, $675.

h. Paid office salaries, $1,800.

i. Determined that the cost of supplies on hand was $380; therefore, the cost of supplies used was $970.

j. Withdrew cash for personal use, $1,500.

Instructions

1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash + Accounts Receivable + Supplies</td>
<td>Accounts Payable + Pamela Larsen, Capital</td>
<td></td>
</tr>
</tbody>
</table>

Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.

2. Briefly explain why the owner’s investment and revenues increased owner’s equity, while withdrawals and expenses decreased owner’s equity.

Following are the amounts of the assets and liabilities of Greco Travel Agency at December 31, 2006, the end of the current year, and its revenue and expenses for the year. The capital of Petrea Kraft, owner, was $16,200 on January 1, 2006, the beginning of the current year. During the current year, Kraft withdrew $47,000.

| Accounts payable | $ 5,120 | Rent expense | $36,000 |
| Accounts receivable | 31,200 | Supplies | 3,000 |
| Cash | 11,520 | Supplies expense | 4,500 |
| Fees earned | 188,000 | Utilities expense | 16,500 |
| Miscellaneous expense | 2,800 | Wages expense | 56,800 |

Instructions

1. Prepare an income statement for the current year ended December 31, 2006.

2. Prepare a statement of owner’s equity for the current year ended December 31, 2006.


Lynn Rosberg established Jack-in-the-Pulpit Financial Services on January 1, 2006. Jack-in-the-Pulpit Financial Services offers financial planning advice to its clients. The effect of each transaction and the balances after each transaction for January are as follows:
Chapter 1 • Introduction to Accounting and Business

Assets = Liabilities + Owner’s Equity

<table>
<thead>
<tr>
<th>Accounts</th>
<th>Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Payable</td>
</tr>
<tr>
<td>+30,000</td>
<td>+30,000 Investment</td>
</tr>
<tr>
<td>Receivable</td>
<td>Lynn Rosberg, Capital</td>
</tr>
<tr>
<td>+3,180</td>
<td>+3,180</td>
</tr>
<tr>
<td>Supplies</td>
<td>+3,180</td>
</tr>
<tr>
<td>+3,180</td>
<td>+3,180</td>
</tr>
<tr>
<td>Bal.</td>
<td>Bal.</td>
</tr>
<tr>
<td>30,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Instructions

On July 1, 2006, Beth Nesbit established Patriotic Realty. Nesbit completed the following transactions during the month of July:

a. Opened a business bank account with a deposit of $18,000 from personal funds.
b. Purchased supplies (pens, file folders, fax paper, etc.) on account, $1,650.
c. Paid creditor on account, $1,100.
e. Paid rent on office and equipment for the month, $7,200.
f. Withdrew cash for personal use, $10,000.
g. Paid automobile expenses (including rental charge) for month, $1,500, and miscellaneous expenses, $750.
h. Paid office salaries, $8,000.
i. Determined that the cost of supplies on hand was $600; therefore, the cost of supplies used was $1,050.

Instructions
1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

   Assets = Liabilities + Owner’s Equity

   Cash + Supplies = Accounts Payable + Beth Nesbit, Capital

   Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.

Daisy Dry Cleaners is owned and operated by Gloria Carson. A building and equipment are currently being rented, pending expansion to new facilities. The actual work of dry cleaning is done by another company at wholesale rates. The assets and the liabilities of the business on March 1, 2006, are as follows: Cash, $7,150;
Accounts Receivable, $12,880; Supplies, $3,400; Land, $20,000; Accounts Payable, $6,360. Business transactions during March are summarized as follows:

a. Received cash from cash customers for dry cleaning sales, $22,000.
b. Paid rent for the month, $3,500.
c. Purchased supplies on account, $2,100.
d. Paid creditors on account, $4,800.
e. Charged customers for dry cleaning sales on account, $11,700.
f. Received monthly invoice for dry cleaning expense for March (to be paid on April 10), $8,400.
g. Paid the following: wages expense, $3,400; truck expense, $1,580; utilities expense, $960; miscellaneous expense, $630.
h. Received cash from customers on account, $10,100.
i. Determined that the cost of supplies on hand was $2,600; therefore, the cost of supplies used during the month was $2,900.
j. Withdrew $6,000 cash for personal use.

Instructions

1. Determine the amount of Gloria Carson’s capital as of March 1 of the current year.
2. State the assets, liabilities, and owner’s equity as of March 1 in equation form similar to that shown in this chapter. In tabular form below the equation, indicate increases and decreases resulting from each transaction and the new balances after each transaction. Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.
3. Prepare an income statement for March, a statement of owner’s equity for March, and a balance sheet as of March 31.

The financial statements at the end of Zeppelin Realty’s first month of operations are shown below and on the next page.

### Zeppelin Realty

#### Income Statement
For the Month Ended November 30, 2006

<table>
<thead>
<tr>
<th>Fees earned</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Wages expense</td>
<td>$8,500.00</td>
</tr>
<tr>
<td>Rent expense</td>
<td>3,200.00</td>
</tr>
<tr>
<td>Supplies expense</td>
<td>(b)</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>1,800.00</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>1,100.00</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>17,600.00</td>
</tr>
<tr>
<td>Net income</td>
<td>$12,400.00</td>
</tr>
</tbody>
</table>

### Zeppelin Realty

#### Statement of Owner’s Equity
For the Month Ended November 30, 2006

<table>
<thead>
<tr>
<th>Craig Haas, capital, November 1, 2006</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment on November 1, 2006</td>
<td>$40,000.00</td>
</tr>
<tr>
<td>Net income for November</td>
<td>(d)</td>
</tr>
<tr>
<td>Less withdrawals</td>
<td>6,000.00</td>
</tr>
<tr>
<td>Increase in owner’s equity</td>
<td>(f)</td>
</tr>
<tr>
<td>Craig Haas, capital, November 30, 2006</td>
<td>(g)</td>
</tr>
</tbody>
</table>
Instructions

By analyzing the interrelationships among the four financial statements, determine the proper amounts for (a) through (q).

Zeppelin Realty
Balance Sheet
November 30, 2006

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 580,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>220,000</td>
</tr>
<tr>
<td>Land</td>
<td>400,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>(h)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Owners' Equity</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Craig Haas, capital</td>
<td>(i)</td>
</tr>
<tr>
<td>Total liabilities and owner's equity</td>
<td>(j)</td>
</tr>
</tbody>
</table>

Zeppelin Realty
Statement of Cash Flows
For the Month Ended November 30, 2006

<table>
<thead>
<tr>
<th>Cash flows from operating activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from customers</td>
<td>$ (k)</td>
</tr>
<tr>
<td>Deduct cash payments for expenses and payments to creditors</td>
<td>182,000</td>
</tr>
<tr>
<td>Net cash flow from operating activities</td>
<td>$ (l)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from investing activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash payments for acquisition of land</td>
<td>(m)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from financing activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received as owner's investment</td>
<td>(n)</td>
</tr>
<tr>
<td>Deduct cash withdrawal by owner</td>
<td>(o)</td>
</tr>
<tr>
<td>Net cash flow from financing activities</td>
<td>(p)</td>
</tr>
<tr>
<td>Net cash flow and November 30, 2006 cash balance</td>
<td>(q)</td>
</tr>
</tbody>
</table>

Continuing Problem

Shannon Burns enjoys listening to all types of music and owns countless CDs and tapes. Over the years, Shannon has gained a local reputation for knowledge of music from classical to rap and the ability to put together sets of recordings that appeal to all ages.

During the last several months, Shannon served as a guest disc jockey on a local radio station. In addition, Shannon has entertained at several friends’ parties as the host deejay.

On April 1, 2006, Shannon established a proprietorship known as Dancin Music. Using an extensive collection of CDs and tapes, Shannon will serve as a disc jockey on a fee basis for weddings, college parties, and other events. During April, Shannon entered into the following transactions:

1. Deposited $7,000 in a checking account in the name of Dancin Music.
2. Received $2,000 from a local radio station for serving as the guest disc jockey for April.
April 2. Agreed to share office space with a local real estate agency, Folsom Realty. Dancin Music will pay one-fourth of the rent. In addition, Dancin Music agreed to pay a portion of the salary of the receptionist and to pay one-fourth of the utilities. Paid $1,000 for the rent of the office.

4. Purchased supplies (blank cassette tapes, poster board, extension cords, etc.) from Rockne Office Supply Co. for $350. Agreed to pay $100 within 10 days and the remainder by May 3, 2006.

6. Paid $600 to a local radio station to advertise the services of Dancin Music twice daily for two weeks.

8. Paid $650 to a local electronics store for renting digital recording equipment.

12. Paid $200 (music expense) to Rocket Music for the use of its current music demos to make various music sets.

13. Paid Rockne Office Supply Co. $100 on account.

16. Received $150 from a dentist for providing two music sets for the dentist to play for her patients.

22. Served as disc jockey for a wedding party. The father of the bride agreed to pay $1,200 the 1st of May.

25. Received $500 from a friend for serving as the disc jockey for a cancer charity ball hosted by the local hospital.

29. Paid $240 (music expense) to Score Music for the use of its library of music demos.

30. Received $900 for serving as disc jockey for a local club’s monthly dance.

30. Paid Folsom Realty $400 for Dancin Music’s share of the receptionist’s salary for April.

30. Paid Folsom Realty $300 for Dancin Music’s share of the utilities for April.

30. Determined that the cost of supplies on hand is $170. Therefore, the cost of supplies used during the month was $180.

30. Paid miscellaneous expenses, $150.

30. Paid $500 royalties (music expense) to Federated Clearing for use of various artists’ music during the month.


**Instructions**

1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

<table>
<thead>
<tr>
<th>Assets</th>
<th>= Liabilities + Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash + Accounts Receivable + Supplies</td>
<td>Accounts Payable + Shannon Burns, Capital</td>
</tr>
</tbody>
</table>

   Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.


**Special Activities**

**ACTIVITY 1-1**

*Ethics and professional conduct in business*

Sue Alejandro, president of Tobago Enterprises, applied for a $300,000 loan from First National Bank. The bank requested financial statements from Tobago Enterprises as a basis for granting the loan. Sue has told her accountant to provide the bank with a balance sheet. Sue has decided to omit the other financial statements because there was a net loss during the past year.
In groups of three or four, discuss the following questions:

1. Is Sue behaving in a professional manner by omitting some of the financial statements?

2. a. What types of information about their businesses would owners be willing to provide bankers? What types of information would owners not be willing to provide?

   b. What types of information about a business would bankers want before extending a loan?

   c. What common interests are shared by bankers and business owners?

**ACTIVITY 1-2**  
**Business strategy**

Assume that you are the chief executive officer for Gold Kist Inc., a national poultry producer. The company’s operations include hatching chickens through the use of breeder stock and feeding, raising, and processing the mature chicks into finished products. The finished products include breaded chicken nuggets and patties and deboned, skinless, and marinated chicken. Gold Kist sells its products to schools, military services, fast food chains, and grocery stores.

In groups of four or five, discuss the following business strategy and risk issues:

1. In a commodity business like poultry production, what do you think is the dominant business strategy? What are the implications in this dominant strategy for how you would run Gold Kist?

2. Identify at least two major business risks for operating Gold Kist.

3. How could Gold Kist try to differentiate its products?

**ACTIVITY 1-3**  
**Net income**

On January 3, 2005, Dr. Rosa Smith established First Opinion, a medical practice organized as a proprietorship. The following conversation occurred the following August between Dr. Smith and a former medical school classmate, Dr. Brett Wommack, at an American Medical Association convention in Nassau.

*Dr. Wommack:* Rosa, good to see you again. Why didn’t you call when you were in Las Vegas? We could have had dinner together.

*Dr. Smith:* Actually, I never made it to Las Vegas this year. My husband and kids went up to our Lake Tahoe condo twice, but I got stuck in New York. I opened a new consulting practice this January and haven’t had any time for myself since.

*Dr. Wommack:* I heard about it . . . First . . . something . . . right?

*Dr. Smith:* Yes, First Opinion. My husband chose the name.

*Dr. Wommack:* I’ve thought about doing something like that. Are you making any money? I mean, is it worth your time?

*Dr. Smith:* You wouldn’t believe it. I started by opening a bank account with $60,000, and my July bank statement has a balance of $240,000. Not bad for seven months—all pure profit.

*Dr. Wommack:* Maybe I’ll try it in Las Vegas. Let’s have breakfast together tomorrow and you can fill me in on the details.

---

**Comment on Dr. Smith’s statement that the difference between the opening bank balance ($60,000) and the July statement balance ($240,000) is pure profit.**

**ACTIVITY 1-4**  
**Transactions and financial statements**

Dawn Ivy, a junior in college, has been seeking ways to earn extra spending money. As an active sports enthusiast, Dawn plays tennis regularly at the Racquet Club, where her family has a membership. The president of the club recently approached Dawn with the proposal that she manage the club’s tennis courts. Dawn’s primary duty would be to supervise the operation of the club’s four indoor and six outdoor courts, including court reservations.

In return for her services, the club would pay Dawn $150 per week, plus Dawn could keep whatever she earned from lessons and the fees from the use of the ball machine. The club and Dawn agreed to a one-month trial, after which both would consider an arrangement for the remaining two years of Dawn’s college career. On
this basis, Dawn organized Deuce. During June 2005, Dawn managed the tennis courts and entered into the following transactions:

a. Opened a business account by depositing $1,000.
b. Paid $320 for tennis supplies (practice tennis balls, etc.).
c. Paid $160 for the rental of videotape equipment to be used in offering lessons during June.
d. Arranged for the rental of two ball machines during September for $200. Paid $140 in advance, with the remaining $60 due July 1.
e. Received $1,600 for lessons given during June.
f. Received $300 in fees from the use of the ball machines during June.
g. Paid $600 for salaries of part-time employees who answered the telephone and took reservations while Dawn was giving lessons.
h. Paid $150 for miscellaneous expenses.
i. Received $600 from the club for managing the tennis courts during June.
j. Determined that the cost of supplies on hand at the end of the month totaled $150; therefore, the cost of supplies used was $170.
k. Withdrew $800 for personal use on June 30.

As a friend and accounting student, you have been asked by Dawn to aid her in assessing the venture.

1. Indicate the effect of each transaction and the balances after each transaction, using the following tabular headings:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Supplies</td>
<td>Accounts Payable</td>
</tr>
</tbody>
</table>

   Explain the nature of each increase and decrease in owner’s equity by an appropriate notation at the right of the amount.

2. Prepare an income statement for June.
3. Prepare a statement of owner’s equity for June.
4. Prepare a balance sheet as of June 30.

5. a. Assume that Dawn Ivy could earn $8 per hour working 30 hours as a waitress. Evaluate which of the two alternatives, working as a waitress or operating Deuce, would provide Dawn with the most income per month.

   b. Discuss any other factors that you believe Dawn should consider before discussing a long-term arrangement with the Racquet Club.

By satisfying certain specific requirements, accountants may become certified as public accountants (CPAs), management accountants (CMAs), or internal auditors (CIAs). Find the certification requirements for one of these accounting groups by accessing the appropriate Internet site listed below.

<table>
<thead>
<tr>
<th>Site</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><a href="http://www.ais-cpa.com">http://www.ais-cpa.com</a></td>
<td>This site lists the address and/or Internet link for each state's board of accountancy. Find your state’s requirements.</td>
</tr>
<tr>
<td><a href="http://www.imanet.org">http://www.imanet.org</a></td>
<td>This site lists the requirements for becoming a CMA.</td>
</tr>
<tr>
<td><a href="http://www.theiia.org">http://www.theiia.org</a></td>
<td>This site lists the requirements for becoming a CIA.</td>
</tr>
</tbody>
</table>

Amazon.com, an Internet retailer, was incorporated in July 1994, and opened its virtual doors on the Web in July 1995. On the statement of cash flows, would you expect Amazon.com's net cash flows from operating, investing, and financing activities to be positive or negative for each year, 1996, 1997, and 1998? Use the following format for your answers, and briefly explain your logic.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net cash flows from operating activities</th>
<th>Net cash flows from investing activities</th>
<th>Net cash flows from financing activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>positive</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The now defunct **Enron Corporation**, headquartered in Houston, Texas, provided products and services for natural gas, electricity, and communications to wholesale and retail customers. Enron’s operations were conducted through a variety of subsidiaries and affiliates that involved transporting gas through pipelines, transmitting electricity, and managing energy commodities. The following data were taken from Enron’s December 31, 2000 financial statements.

<table>
<thead>
<tr>
<th>Description</th>
<th>In millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>$100,789</td>
</tr>
<tr>
<td>Total costs and expenses</td>
<td>98,836</td>
</tr>
<tr>
<td>Operating income</td>
<td>1,953</td>
</tr>
<tr>
<td>Net income</td>
<td>979</td>
</tr>
<tr>
<td>Total assets</td>
<td>65,503</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>54,033</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>11,470</td>
</tr>
<tr>
<td>Net cash flows from operating activities</td>
<td>4,779</td>
</tr>
<tr>
<td>Net cash flows from investing activities</td>
<td>(4,264)</td>
</tr>
<tr>
<td>Net cash flows from financing activities</td>
<td>571</td>
</tr>
<tr>
<td>Net increase in cash</td>
<td>1,086</td>
</tr>
</tbody>
</table>

At the end of 2000, the market price of Enron’s stock was approximately $83 per share. By March 15, 2002, Enron’s stock was selling for $0.22 per share.

Review the preceding financial statement data and search the Internet for articles on Enron Corporation. Briefly explain why Enron’s stock dropped so dramatically in such a short time.

---

**Answers to Self-Examination Questions**

1. **D** A corporation, organized in accordance with state or federal statutes, is a separate legal entity in which ownership is divided into shares of stock (answer D). A proprietorship (answer A) is an unincorporated business owned by one individual. A service business (answer B) provides services to its customers. It can be organized as a proprietorship, partnership, corporation, or limited liability corporation. A partnership (answer C) is an unincorporated business owned by two or more individuals.

2. **A** The resources owned by a business are called assets (answer A). The debts of the business are called liabilities (answer B), and the equity of the owners is called owner’s equity (answer D). The relationship between assets, liabilities, and owner’s equity is expressed as the accounting equation (answer C).

3. **A** The balance sheet is a listing of the assets, liabilities, and owner’s equity of a business at a specific date (answer A). The income statement (answer B) is a summary of the revenue and expenses of a business for a specific period of time. The statement of owner’s equity (answer C) summarizes the changes in owner’s equity for a proprietorship or partnership during a specific period of time. The statement of cash flows (answer D) summarizes the cash receipts and cash payments for a specific period of time.

4. **C** The accounting equation is:

   \[ \text{Assets} = \text{Liabilities} + \text{Owner's Equity} \]

   Therefore, if assets increased by $20,000 and liabilities increased by $12,000, owner’s equity must have increased by $8,000 (answer C), as indicated in the following computation:

   \[
   \begin{align*}
   \text{Assets} & = \text{Liabilities} + \text{Owner's Equity} \\
   +$20,000 & = +$12,000 + \text{Owner's Equity} \\
   +$20,000 - $12,000 & = \text{Owner's Equity} \\
   +$8,000 & = \text{Owner's Equity}
   \end{align*}
   \]

5. **B** Net income is the excess of revenue over expenses, or $7,500 (answer B). If expenses exceed revenue, the difference is a net loss. Withdrawals by the owner are the opposite of the owner’s investing in the business and do not affect the amount of net income or net loss.