Chapter 1

Accounting in Action

What is Accounting?

STUDY OBJECTIVE 1

Accounting is an information system that
Identifies
Records
Communicates the economic events of an organization to
interested users

Questions Asked by Internal Users

STUDY OBJECTIVE 2
QUESTIONS ASKED BY EXTERNAL USERS

- Accounting
  Includes bookkeeping
  Also includes much more

- Bookkeeping
  The recording of economic events
  One part of accounting

BOOKKEEPING DISTINGUISHED FROM ACCOUNTING

THE ACCOUNTING PROFESSION

- Public Accountants
  Service to the general public through the services they perform.

- Private Accountants
  Individuals in companies involved in activities including cost and tax accounting, systems, and internal auditing.

- Not For Profit Accountants
  Reporting and control for government units, foundations, hospitals, labor unions, colleges/universities, and charities.

THE BUILDING BLOCKS OF ACCOUNTING

- Ethics
  Standards by which actions are judged as right or wrong, honest or dishonest.

- Generally Accepted Accounting Principles
  Established by the F.A.S.B and the S.E.C.

- Assumptions
  - Monetary Unit
    Only data that can be expressed in terms of money is included in the accounting records.
  - Economic Entity
    Includes any organization or unit in society.

BUSINESS ENTERPRISES

- Proprietorship
  Owned by one person.

- Partnership
  Owned by two or more persons.

- Corporation
  Organized as a separate legal entity under state corporation law and having ownership divided into transferable shares of stock.

Review

The accounting process is correctly sequenced as

a. identification, recording, communication.
b. identification, communication, recording.
c. recording, communication, identification.
d. communication, recording, identification.

Chapter 1
Review

The accounting process is correctly sequenced as:

a. identification, communication, recording.
b. recording, communication, identification.
c. identification, recording, communication.
d. communication, recording, identification.

ASSETS AS A BUILDING BLOCK

- **Assets** are resources owned by a business.
- They are used in carrying out such activities as production, consumption and exchange.

OWNERS EQUITY AS A BUILDING BLOCK

- **Owner’s Equity** = total assets minus total liabilities. (A - L = O.E.)
- **Owner’s Equity** represents the ownership claim to total assets.
- **Subdivisions of Owner’s Equity:**
  1. Capital or Investments by Owner (+)
  2. Drawing (-)
  3. Revenues (+)
  4. Expenses (-)

LIABILITIES AS A BUILDING BLOCK

- **Liabilities**
  - are creditor claims against assets
  - are existing debts and obligations

INVESTMENTS BY OWNERS AS A BUILDING BLOCK

- **Investments**
  - are the assets the owner puts in the business
  - increase owner’s equity

BASIC ACCOUNTING EQUATION

STUDY OBJECTIVE 6

\[
\text{Assets} = \text{Liabilities} + \text{Owner’s Equity}
\]
**DRAWINGS AS A BUILDING BLOCK**

- **Drawings**
  - are withdrawals of cash or other assets by the owner for personal use
  - decrease owner’s equity

**REVENUES AS A BUILDING BLOCK**

- **Revenues**
  - gross increases in owner’s equity from business activities entered into for the purpose of earning income
  - may result from sale of merchandise, services, rental of property, or lending money
  - usually result in an increase in an asset

**EXPENSES AS A BUILDING BLOCK**

Expenses

- decreases in owner’s equity that result from operating the business
- cost of assets consumed or services used in the process of earning revenue
- examples: utility expense, rent expense, supplies expense, and tax expense

**INCREASES AND DECREASES IN OWNER’S EQUITY**

**INCREASES**
- Investments by Owner
- Revenues

**DECREASES**
- Withdrawals by Owner
- Expenses

**TRANSACTION IDENTIFICATION PROCESS**

**STUDY OBJECTIVE 6**

**TRANSACTION ANALYSIS**

**TRANSACTION 1**

- Ray Neal decides to open a computer programming service.
- On September 1, he invests $15,000 cash in the business, which he names **Softbyte**.
**TRANSACTION ANALYSIS**

**TRANSACTION 1 SOLUTION**

- **Equity**
  - Assets = Liabilities + Owner’s Equity
  - Cash = R. Neal, Capital
  - \( + 15,000 \) = \( + 15,000 \)
  - 15,000 = 15,000

There is an increase in the asset Cash, $15,000, and an equal increase in the owner’s equity, R. Neal, Capital, $15,000.

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**TRANSACTION 2**

- **Softbyte purchases computer equipment for $7,000 cash.**

**TRANSACTION ANALYSIS**

**TRANSACTION 2 SOLUTION**

- **Assets = Liabilities + Owner’s Equity**
  - Cash + Equipment = R. Neal, Capital
  - Old
    - Bal. $15,000 = $15,000
  - New
    - Bal. $8,000 + $7,000 = $15,000

Cash is decreased by $7,000 and the asset Equipment is increased by $7,000.

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**TRANSACTION 3**

- **Softbyte purchases supplies expected to last for several months for $1,600 from Acme Supply Company.**
  - Acme agrees to allow Softbyte to pay this bill next month, in October.
  - This transaction is referred to as a purchase on account or a credit purchase.

**TRANSACTION ANALYSIS**

**TRANSACTION 3 SOLUTION**

- **Assets = Liabilities + Owner’s Equity**
  - Cash + Supplies + Equipment = Accts. Pay. + R. Neal, Capital
  - Old
    - \( +8,000 \) + \( +7,000 \) = \( +15,000 \)
  - New
    - \( +8,000 \) \( +1,600 \) \( +7,000 \) = \( +1,600 \) \( +15,000 \)

The asset Supplies is increased by $1,600, and the liability Accounts Payable is increased by the same amount.

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**TRANSACTION 4**

- **Softbyte receives $1,200 cash from customers for programming services it has provided.**
  - This transaction represents the Softbyte’s principal revenue-producing activity.

**TRANSACTION ANALYSIS**

**TRANSACTION 4 SOLUTION**

- **Assets = Liabilities + Owner’s Equity**
  - Cash + Supplies + Equipment = Accts. Pay. + R. Neal, Capital
  - Old
    - \( +8,000 \) + \( +7,000 \) = \( +15,000 \)
  - New
    - \( +8,000 \) \( +1,600 \) \( +7,000 \) = \( +1,600 \) \( +15,000 \)

The asset Supplies is increased by $1,600, and the liability Accounts Payable is increased by the same amount.
TRANSACTION ANALYSIS

TRANSACTION 4 SOLUTION

• Assets = Liabilities + Owner’s Equity

  • Old $8,000 + $1,600 + $7,000 = $1,600 + $15,000
  • (4) + 1,200
  • New $9,200 + $1,600 + $7,000 = $1,600 + $16,200

• Cash is increased by $1,200 and R. Neal, Capital is increased by $1,200

Cash is increased by $1,200 and R. Neal, Capital is increased by $1,200

TRANSACTION ANALYSIS

TRANSACTION 5

• Softbyte receives a bill for $250 from the Daily News for advertising but postpones payment of the bill until a later date.

Cash is increased by $1,200; Accounts Payable is increased by $250

TRANSACTION ANALYSIS

TRANSACTION 6

• Softbyte provides $3,500 of programming services for customers.

- Cash of $1,500 is received from customers, and the balance of $2,000 is billed on account.

Cash is increased by $1,500; Accounts Receivable is increased by $2,000, and R. Neal, Capital is increased by $3,500

TRANSACTION ANALYSIS

TRANSACTION 7

• Expenses paid in cash for September are store rent, $600; employees’ salaries, $900; and utilities, $200.
TRANSACTION ANALYSIS

TRANSACTION 7 SOLUTION

• Assets
  = Liabilities + Owner’s Equity
• Old
  $19,450 + $2,000 + $1,600 + $7,000 = $1,850 + $19,450
• (7)
  Rent Expense - 600
  Salaries Expense - 900
  Utilities Expense - 200
  New
  $9,000 + $2,000 + $1,600 + $7,000 = $1,850 + $17,750
  $19,600 - 1,700 = $19,600

Cash is decreased by $1,700 and R. Neal, Capital is decreased by the same amount.

TRANSACTION ANALYSIS

TRANSACTION 8 SOLUTION

• Softbyte pays its $250 Daily News advertising bill in cash.

TRANSACTION ANALYSIS

TRANSACTION 9 SOLUTION

• The sum of $600 in cash is received from customers who have previously been billed for services (in Transaction 6).

TRANSACTION ANALYSIS

TRANSACTION 10 SOLUTION

• Ray Neal withdraws $1,300 in cash from the business for his personal use.
Cash is decreased $1,300 and R. Neal, Capital is decreased by the same amount.

Assets = Liabilities + Owner's Equity

Old Bal. $9,350 + $1,400 + $1,600 + $7,000 = $1,600 + $17,750
10

-1,300

New Bal. $8,050 + $1,400 + $1,600 + $7,000 = $1,600 + $16,450

Cash is decreased by $1,300 and R. Neal, Capital is decreased by the same amount. This is not an expense, but rather a withdrawal of owner's equity.

Four financial statements are prepared from the summarized accounting data:

- Income Statement
  Revenues and expenses and resulting net income or net loss for a specific period of time
- Owner’s Equity Statement
  Changes in owner’s equity for a specific period of time
- Balance Sheet
  Assets, liabilities, and owner’s equity at a specific date
- Statement of Cash Flows
  Cash inflows (receipts) and outflows (payments) for a specific period of time

Net income of $2,750 shown on the income statement is added to the beginning balance of owner’s capital in the owner’s equity statement.

Net income of $2,750 is determined from the information in the owner’s equity column of the Summary of Transactions (Illustration 1-8).
SOFTBYTE, INC.
Balance Sheet
September 30, 2005

Assets
Cash $  8,050
Accounts receivable 1,400
Supplies 1,600
Equipment 7,000
Total assets $ 18,050

Liabilities and Owner’s Equity
Liabilities
Accounts payable $  1,600
Owner’s equity
R. Neal, capital 16,450
Total liabilities and owner’s equity $ 18,050

Owner’s capital of $16,450 at the end of the reporting period shown in the owner’s equity statement is shown on the balance sheet.

SOFTBYTE, INC.
Balance Sheet
September 30, 2005

Assets
Cash $  8,050
Accounts receivable 1,400
Supplies 1,600
Equipment 7,000
Total assets $ 18,050

Liabilities and Owner’s Equity
Liabilities
Accounts payable $  1,600
Owner’s equity
R. Neal, capital 16,450
Total liabilities and owner’s equity $ 18,050

Cash of $8,050 on the balance sheet is reported on the statement of cash flows.

SOFTBYTE, INC.
Statement of Cash Flows
For the Month Ended September 30, 2005

Cash flows from operating activities
Cash receipts from revenues $  3,300
Cash payments for expenses (1,950)
Net cash provided by operating activities 1,350

Cash flows from investing activities
Purchase of equipment (7,000)

Cash flows from financing activities
Sale of common stock $ 15,000
Payment of cash dividends (1,300)
Net cash provided by financing activities 13,700

Net increase in cash 8,050
Cash at the beginning of the period –0–
Cash at the end of the period $ 8,050

Cash of $8,050 on the balance sheet and statement of cash flows is shown as the final total of the cash column of the Summary of Transactions (Illustration 1-7).

SOFTBYTE, INC.
Balance Sheet
September 30, 2005

Assets
Cash $  8,050
Accounts receivable 1,400
Supplies 1,600
Equipment 7,000
Total assets $ 18,050

Liabilities and Owner’s Equity
Liabilities
Accounts payable $  1,600
Owner’s equity
R. Neal, capital 16,450
Total liabilities and owner’s equity $ 18,050

Cash of $8,050 on the balance sheet is reported on the statement of cash flows.

Chapter 1

Which of the following is not an advantage of the corporate form of business organization?

a. Limited liability of stockholders
b. Transferability of ownership
c. Unlimited personal liability for stockholders
d. Unlimited life

Chapter 1