

# CHAPTER 1

## Introduction to Accounting

—*What Accounting is*

What is accounting? 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, 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 obtain a higher-paying job or a more desirable job).

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

### 1.1 What is Accounting

Accounting is the language of business. Its purpose is to provide useful information to a variety of users so that they can make informed decisions. These users of accounting information may include owners, managers, creditors, government agencies, customers, labor unions and competitors.

#### 1.1.1 Accounting: the Language of Business

Accounting is often called the “language of business”. A language is a means of social communication and involves a flow of information from one person to one or more other persons. To be effective, the receiver of the information must understand

the message that the sender intends to convey. Accounting uses its own special words and symbols to communicate financial information that is intended to be useful for economic decision making by managers, shareholders, creditors and many others. As you study accounting, you must learn the meanings of these words and symbols if you want to understand the messages contained in financial reports. Everyone involved in business, from the beginning employee to the top manager, eventually uses accounting information in decision-making process.

Business people often call accounting the “language of business” because they use accounting data in communicating about a firm’s activities. Information provided by accountants helps managers and other executives understand the results of business transactions and interpret the financial status of their organization. With this knowledge, manager can make decisions about such matters as production, marketing, financing.

In addition, charities, churches, colleges, government agencies, and nonprofit organization also use accounting to keep track of their financial situation.

### **1.1.2 Accounting: an Information System**

Accounting is an information system necessitated by the great complexity of modern business.

#### **Basic Functions of an Accounting System:**

In developing information about the activities of a business, every accounting system performs the following basic functions:

(1) Interpret and record the effects of business transactions.

(2) Classify the effects of similar transactions in a manner that permits determination of the various totals and subtotals useful to management and used in accounting reports.

(3) Summarize and communicate the information contained in the system to decision makers.

Accounting systems are designed to provide information that managers and outsiders can use in decision making. They also serve other purposes: to produce op-

erating documents, to protect the company's assets, to provide data for company tax returns, and, in some cases, to provide the basis for reimbursement of costs by clients or customers. The accounting organization also must prepare documents that serve what might be called private information purposes, such as the employees' own records of their salaries and wages. Many of these documents aim serve other accounting purposes, but they would have to be prepared even if no information reports were necessary. Measured by the number of people involved and the amount of time required, document preparation is one of accounting's biggest jobs.

Accounting is a system of gathering, summarizing, and communicating financial information for a business firm, government, or other organization. Accounting, also called accountancy, enables decision makers to interpret financial information and, use results in planning for the future. For example, such data tell executives which products or departments are doing well and which poorly.

### **1.1.3 Accounting: the Basis for Decision Making**

Accounting is the basis for decision making. Its purpose is to provide useful information to a variety of users so they can make informed decisions.

Accounting and accounting information are used more than commonly realized. The following sections discuss the range of people and group who use accounting information and decisions they make.

## **1.2 The Role of Accounting**

It has been said that accounting is the language of business. Every part of business is affected by accounting. Management of a business depends on financial information in making sound operational decisions. Stockholders must have financial information in order to measure management's performance and to evaluate their own holdings. Potential investors need financial data in order to compare prospective investments. Creditors must consider the financial strength of a business before permitting it to borrow funds. Also, many laws require that extensive financial in-

formation be reported to the various governmental agencies at least annually.

### **Decision Makers Who Use Accounting Information**

Decision makers need information. The more important the decision, the greater the need. All businesses and most individuals keep accounting records to aid in making decisions. If managers in a business made in designing a slogan to expand the company. The result might be the company's income statement. Let's look at some decision makers who use accounting information as follows.

#### **Individuals:**

Individual often keeps accounting records to aid decision-making. People often use accounting information to manage their bank accounts, to evaluate job prospects, and to decide whether to rent an apartment or buy a house.

#### **Businesses:**

Managers of businesses use accounting information to set goals, to evaluate progress toward those goals, and to take corrective action if necessary. Decisions based on accounting information may include where to locate a store, how many goods to keep on hand, and how much cash to borrow.

#### **Investors and Creditors:**

Investors and creditors provide the money a business needs to get started. When a company opened its first store, the company had no track record. To decide whether to help start a new venture, potential investors evaluate what income they can expect on their investment. This means analyzing the financial statements of the business. Before deciding to invest in a company, for example, you may examine the company's financial statements. Before making a loan to the company, banks evaluate the company's ability to meet scheduled payments.

#### **Government Regulatory Agencies:**

Most organizations face government regulation. For example, the Securities and Exchange Commission (SEC), a federal agency, requires businesses to report certain financial information to the investing public. The other companies publish annual reports.

#### **Taxing Authorities:**



Local, state, and federal governments levy taxes on individuals and businesses. A company pays property tax on its assets and income tax on its profits. The company also collects sales tax from customers and forwards the money to the government. Individuals pay income tax on their earnings. All of these taxes are based on accounting data.

**Nonprofit Organizations:**

Nonprofit organizations—such as churches, hospitals, and government agencies, which operate for purposes other than profit—use accounting information as profit-oriented businesses do. Both for profit organizations and nonprofit organizations deal with payrolls, rent payments, and the like information from the accounting system.

**Other Users:**

Employees and labor unions demand wages that come from the employer’s reported income. And newspapers report “improved profit pictures” of companies. Such news, which depends on accounting, reports information that affects our standard of living.

Decision makers who use accounting information can be illustrated as below (Figure 1–1).

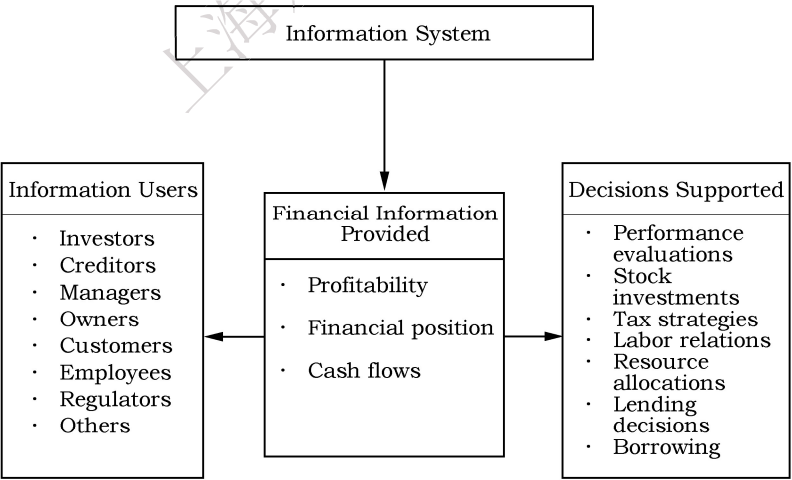


Figure 1–1 Decision Makers Who Use Accounting Information

## 1.3 Accounting and Bookkeeping

Persons with little knowledge of accounting may fail to understand the difference between accounting and bookkeeping. Bookkeeping means the recording of transactions, the Record-making phase of accounting. The recording tends to be mechanical and repetitive, it is only a small part of the field of accounting and probably the simplest part. At the computer times, people are using computers to do detailed bookkeeping.

However, accounting includes not only the maintenance of accounting records, but also the design of efficient accounting systems, the performance of audits, the development of forecasts, the planning of income tax, and the interpretation of accounting information. Because the work of interpreting accounting information is such an important part of the accountant's function, accounting has usually been described as an art. A person might become a reasonably proficient bookkeeper in a few weeks or months however, to be a qualified professional accountant or a certified public accountant requires several years of study and experience.

### **The Difference Between Accounting and Bookkeeping**

#### **Accountant:**

An accountant is a professional with the education and experience to design an accounting system, prepare reports, and interpret their results. Some people think that the work of professional accountants consists primarily of bookkeeping. Actually, it doesn't. In fact, many professional accountants do little or no bookkeeping.

Professional accountants are involved more with the interpretation and use of accounting information than with its actual preparation. Their work includes evaluating the efficiency of operations, resolving complex financial reporting issues, forecasting the results of future operations, auditing, tax planning, and designing efficient accounting systems. There is very little that is "routine" about the work of a professional accountant.

#### **Bookkeeper:**

Bookkeeping is the clerical side of accounting—the recording of routine transactions and day-to-day record keeping. A person who solely records accounting information is referred to as a bookkeeper. Today such tasks are performed primarily by computers and skilled clerical personnel, not by accountants.

It is important to clarify the relationship of accounting to bookkeeping and the computer to avoid certain misunderstandings about accounting.

## 1.4 The Accounting Process

Accounting is the process of (1) analyzing, (2) recording, (3) classifying, (4) summarizing, (5) reporting, and (6) interpreting. These six major phases of the accounting process are described below.

**Analyzing** is the first phase of the accounting process. The accountant must look at a transaction or event and determine its importance to the business.

**Recording** these transactions is the second phase. Traditionally this meant writing something by hand. Even today, much of the record keeping in accounting is done manually. However, some major changes in the business world have been caused by the introduction of computers. Even though the method of entering or recording accounting information has changed, the concept behind the process has not.

**Classifying**, phase three of the process, relates to the grouping of like transactions together rather than keeping a narrative record of many transactions. Like items are grouped in separate accounts.

**Summarizing** is the process of bringing together various items of information to determine or explain a result.

**Reporting** involves communicating results. In accounting it is common to use tables of numbers rather than narrative-type reports. Sometimes, however, a combination of tables and narratives is used.

**Interpreting** the reported results is the final phase of the process. At this time, attention is directed to the significance of various matters and relationships. Per-

centage analyses and ratios are often used to help explain the difference among accounting periods. Footnotes and special captions also may be valuable in the interpreting phase of accounting.

## 1.5 Accounting Today

Accounting is one of the fastest growing fields in the modern business world. Every new store, school, restaurant, or filling station indeed, any new enterprise of any kind increases the demand for accountants. Consequently, the demand for accountants is generally much greater than the supply. Government officials often have a legal background; similarly, the men and women in management often have a background in accounting. They are usually familiar with the methodology of finance and fundamentals of fiscal and business administration.

Today's accountants are as diverse as their job assignments. Accountants may be male or female, outgoing or conservative, but they are all analytical. They may have backgrounds in art history or computer programming. They come from every ethnic and cultural background.

An accounting background can open doors in most lines of business. In short, accounting deals with all facets of an organization—purchasing, manufacturing, marketing, and distribution. This is why accounting provides such an excellent basis for business experience.

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### Making Decisions Using Accounting Information

Applying Your Knowledge
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Assume that you have a friend who wants to start a business and needs some help getting the money required to rent space and acquire the needed assets to operate the business (for example, delivery truck, display fixtures) and pay employees

for their work before the doors open and customers begin paying for the products the company plans to sell. You are in a financially strong position and agree to loan your friend \$100 000. Your intent is not to be a long-term investor or co-owner of the business, but rather to help your friend start his company and at the same time earn a **return on** the funds you have loaned him. Assume further that you agree to let your friend have the use of your \$100 000 for one year and, if you had not loaned this amount to him, you could have earned an 7 percent return by placing your money in another investment.

In addition to wanting to help a friend, you are interested in knowing how much risk you are taking with regard to your \$100 000. You expect your friend to pay that \$100 000 back, and to also pay you an additional amount of \$7 000 ( $\$100\,000 \times 7\%$ ) for his use of your money. The **total return of** your investment ( $\$100\,000$ ) back to you one year later, added to the amount you expect to receive for his having used your money for a year ( $\$7\,000$ ), are as follow:

Cash flow from your original investment		\$100 000
Cash flow from a return for allowing another's		
use of your funds	<u>(<math>\\$100\,000 \times 7\%</math>)</u>	<u>\$7 000</u>
Total cash flow expected to be received in one year		\$107 000

Providing information for you to assess your friend's ability to meet his cash flow commitment to you is essentially what financial reporting is about. You need information assess the risk you are taking and the prospects that your friend will be able to deliver \$107 000 to you one year from the time you loan him the \$100 000. While this is a relatively simple example, it sets the stage for your understanding of the kinds of information at will help you make this important investment decision.

Key words, phrases, and special terms

accounting  
information system

会计,会计学  
信息系统

enterprise	企业
business	商业, 企业
decision making	制定决策
bookkeeping	簿记
transaction	交易, 经济业务
investor	投资者
creditor	债权人
nonprofit organization	非营利性组织
return of	(投资)回收
return on	(投资)回报, 报酬
cash flow	现金流量

### Multiple-choice questions

1. Which of the following describe accounting? ( ).
  - a. Is language of business
  - b. Is an information system
  - c. Is an end rather than a means to an end
  - d. Useful for decision making
2. Accounting is an information system that ( ).
  - a. measures business activities
  - b. processes information into reports
  - c. communicates findings to decision-makers
  - d. all of the above
3. Accounting information is used by ( ).
  - a. businesses
  - b. government regulation agencies
  - c. labor unions
  - d. all of the above
4. A procedural element of accounting is ( ).

a. planning

b. control

c. bookkeeping

d. auditing

5. Purposes of an accounting system include all of the following except( ).

a. interpret and record the effects of business transactions

b. classify the effects of transactions to facilitate the preparation of reports

c. summarize and communicate information to decision makers

d. dictate the specific types of business transactions that the enterprise may engage in

6. An accounting process includes all of the following steps except( ).

a. analyzing

b. planning

c. classifying

d. summarizing

7. Purposes of an accounting system include all of the following except( ).

a. interpret and record the effects of business transactions

b. classify the effects of transactions to facilitate the preparation of reports

c. summarize and communicate information to decision makers

d. dictate the specific types of business transactions that the enterprise may engage in

## Cases

1. You are employed by a business consulting firm as an information systems specialist. You have just begun an assignment with a start-up company and are discussing with the owner who need for an accounting system. How would you respond to the following questions from the owner?

(1)What is the meaning of the term accounting system?

(2)What is the purpose of an accounting system and what are its basic func-

tions?

(3) Who is responsible for designing and implementing an accounting system?

2. You are a loan officer at a bank that makes small loans to individuals to help finance purchases such as automobiles and appliances. You are considering an application from a young woman who needs to purchase a new car. She is requesting a loan of \$10 000 which, when combined with the trade-in value of her old car, will allow her to meet her needs. What are your expectations with regard to repayment of the loan, and what information would help you decide whether she is a good credit risk for your bank?

3. Mike and Brown have owned and operated a retail furniture store for more than 20 years. They have employed an independent CPA during this time to prepare various sales tax, payroll tax, and income tax return, as well as financial statements for themselves and the bank from which they have borrowed money from time to time. They are considering selling the store but are uncertain about how to establish an asking price.

What type of information is likely to be included in the material prepared by the CPA that may help Mike and Brown establish an asking price for the store?



## CHAPTER 2

# Accounting Standards

## —*What Govern Accounting Practice*

Accounting practice needs certain guidelines to action. Accounting theory provides the rationale or justification for accounting practice. The accounting theory rests on foundation of basic concepts and assumptions that are very broad, few in number, and derived from accounting practice. The accounting principles provide guidelines or directives to accounting practice.

The accounting profession has developed standards that are generally accepted and universally practiced. This common set of standards is called generally accepted accounting principles (GAAP). Accounting principles are also referred to as standards, assumptions, postulates, and concepts. These standards indicate how to report economic events.

### 2.1 Accounting Assumptions

The most fundamental assumptions underlying the accounting process are: (1) accounting entity, (2) going concern, (3) monetary unit, and (4) periodicity.

#### 2.1.1 Accounting Entity

A major assumption in accounting is that economic activity can be identified with a particular unit of accountability. In other words, the activity of a business enterprise can be kept separate and distinct from its owners and any other business unit. If there were no meaningful way to separate all of the economic events that oc-

cur, no basis for accounting would exist.

Under this concept, for accounting purposes, all kinds of business concerns are conceived and treated as a separate entity, separate and distinct from its owners and from other concerns. Either the transactions or the assets of a concern should not include those of the owner or owners. As for the transactions between the concern and the owners in accounting procedures, they should be treated as those with other concerns. As a result, all the accounting records and reports should be made by a concern as an independent entity rather than by owners personally.

### 2. 1. 2 Going Concern

Most accounting methods are based on the assumption that the business enterprise will have a long life. Experience indicates that, in spite of numerous business failures, companies have a fairly high continuance rate. Although accountants do not believe that business firms will last indefinitely, they do expect them to last long enough to fulfill their objectives and commitments.

The going-concern concept, which holds that the entity will remain in operation for the foreseeable future. Most assets—that is, the firm's resources, such as supplies, land, buildings, and equipment—are acquired for use rather than for sale. Under the going-concern concept, accountants assume that the business will remain in operation long enough to use existing assets for their intended purpose. The market value of an asset the price for which the asset can be sold—may change during the asset's life. Moreover, historical cost is a more reliable accounting measure for assets than market value because cost is a historical fact.

A balance sheet is prepared under the assumption that the concern for which the statement is made will continue in operation, so far a going concern the assets used in carrying on its operations are not for sale. Their current market values are not relevant and need not be shown. Also, without a sale, their current market values usually can not be objectively established as is required by the “objectivity principle”.

### 2.1.3 The Stable Monetary Unit

Accounting is based on the assumption that money is the common denominator by which economic activity is conducted, and that the monetary unit provides an appropriate basis for accounting measurement and analysis. This assumption implies that the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. The monetary unit is relevant, simple, universally available, understandable, and useful. Application of this assumption is dependent on the even more basic assumption that quantitative data are useful in communicating economic information and in making rational economic decisions.

In the United States, accountants record transactions in dollars because the dollar is the medium of exchange. British accountants record transactions in pounds sterling, and Japanese accountants in yen.

Unlike the value of a liter or a mile, the value of a dollar or of a Mexican peso changes over time. A rise in the general price level is called inflation. During inflation, a dollar will purchase less milk, less toothpaste, and less of other goods. When prices are stable—when there is little inflation—a dollar's purchasing power is also stable.

Accountants assume that the dollar's purchasing power is relatively stable. The stable monetary unit concept is the basis for ignoring the effect of inflation in the accounting records. It allows accountants to add and subtract dollar amounts as though each dollar has the same purchasing power as any other dollar at any other time.

### 2.1.4 Accounting Period

Life of a business often lasts many years and its activities go on without interruption over the years. Although the most accurate way to measure the results of enterprise activity would be to measure them at the time of the enterprise's eventual liquidation, business, government, investors, and various other user groups, how-

ever, cannot wait indefinitely for such information. Accountants must provide financial information periodically, so that all users make their decisions upon the information.

The accounting period or time period assumption simply implies that the economic activities of an enterprise can be divided into artificial time periods of equal length. These time periods vary, but the most common are monthly, quarterly, and yearly.

## 2.2 Accounting Basis

There are two basis ways to do accounting: the accrual- basis and the cash basis. Generally accepted accounting principles require that business use the accrual- basis. This means that the business records revenues as they are earned and expenses as they are incurred—not necessarily when cash changes hands.

### 2.2.1 Cash- basis

In cash- basis accounting, the accountant records a transaction only when cash is received or paid. Cash receipts are treated as revenues and payments are handled as expenses. It ignores receivables, payables, and depreciation. Only very small business use the cash- basis.

Under the cash basis, revenues and expenses are reported in the income statement in the period in which cash is received or paid. For example, fees are recorded when cash is received from clients, and wages are recorded when cash is paid to employees. The net income (or net loss) is the difference between the cash receipts (revenues) and the cash payments (expenses).

The cash basis does not emphasize the matching principle. Instead, the receipt or payment of cash governs the recording process. Thus, the income statement under the cash basis could provide an unrealistic picture of the company's operations.

### 2.2.2 Accrual- basis

In accrual- basis accounting, an accountant recognizes the impact of a business

transaction as it occurs. When the business performs a service, makes a sale, or incurs an expense, the accountant must enter the transaction into the journals, whether or not cash has been received or paid. Most business use the accrual- basis.

Under the accrual- basis, revenues are reported in the income statement in the period in which they are earned. For example, revenue is reported when the services are provided to customers. Cash may or may not be received from customers during this period. The concept that supports this reporting of revenues is called the **revenue recognition concept**.

Accrual- basis accounting can provide more complete information than cash- basis accounting does, which is very important for decision- makers.

Accrual- basis accounting is more complex—and more complete—than cash- basis. Accrual- basis accounting records both **cash** transactions, including:

- Collecting from customers
- Receiving cash from interest earned
- Paying salaries, rent, income tax, and other expenses
- Borrowing money
- Paying off loans
- Issuing stock

It also records such **non- cash** transactions as:

- Purchases of inventory on account
- Sales on account
- Accrual of interest and other expenses incurred but not yet paid
- Depreciation expense
- Usage of prepaid insurance, supplies, and other prepaid expenses

The accrual- basis accounting is designed to avoid misleading income statement results that could otherwise result from the timing of cash receipts and payments. If the income statement is to portray a realistic net income figure based upon accrual accounting, all revenues earned during the period and all expenses incurred must be shown. Therefore, it is often necessary to adjust some account balances at the end of each accounting period to achieve a proper matching of costs and expenses with

revenue. The adjusting step occurs after the journals have been posted, but before financial statements are prepared.

## 2.3 Accounting Principles

There are several basic principles of accounting that are used to record transactions: (1) historical cost, (2) realization principle, (3) matching principle, (4) full disclosure, and so on.

### 2.3.1 The Cost Principle —*Valuing Assets*

Traditionally, preparers and users of financial statements have found that cost is generally the most useful basis for accounting measurement and reporting. Under the cost principle, all goods and services purchased by an enterprise are recorded at acquisition cost and appear on financial statement at cost. This is often referred to as the **historical cost principle**.

The cost principle states that acquired assets and services should be recorded at their actual cost (also called historical cost). Even though the purchaser may believe the price paid is a bargain, the item is recorded at the price paid in the transaction and not at the “expected” cost. Suppose your stereo shop purchases stereo equipment from a supplier who is going out of business. Assume that you get a good deal on this purchase and pay only \$2 000 for merchandise that would have cost you \$3 000 elsewhere. The cost principle requires you to record this merchandise at its actual cost of \$2 000, not the \$3 000 that you believe it is worth.

The cost principle also holds that accounting records should maintain the historical cost of an asset for as long as the business holds the asset. Why? Because cost is a reliable measure. Suppose your store holds the stereo equipment for six months. During that time, stereo prices increase and the equipment can be sold for \$3 500. Should its accounting value—the figure “on the books”—be the actual cost of \$2 000 or the current market value of \$3 500? According to the cost principle, the accounting value of the equipment remains at actual cost, \$2 000.

### 2.3.2 The Realization Principle—*Measuring Revenues*

The realization principle means that revenue are usually measured in which they occur, rather than in the period in which they are collected. In other words, this is the period in which goods are shipped or services are rendered, in which revenue is said to be realized. At this point the business has essentially completed the earning process and the sales value of the goods or service can be measured objectively. In most cases, revenue is earned when the business has delivered a completed good or service to the customer. The reason is that the business has done everything required by the agreement, including transferring the item to the customer. At any time prior to sale, the ultimate sales value of the goods or services sold can only be estimated. The revenue should be recognized and reported in the income statement when the timing of revenue is reasonably determinable and the earnings process is completed.

### 2.3.3 The Matching Principle—*Measuring Expenses*

Matching principle requires that revenues and expenses be matched. It is well recognized that a business incurs expenses in order to earn revenues. The revenues earned are the results of the expenses paid. Consequently it is only proper that expenses be matched with the revenues they helped to produce.

In recognizing expenses, accountants attempt to follow the approach of “let the expense follow the revenue.” Expenses are recognized not when wages are paid, or when the work is performed, or when a product is produced, but when the work (service) or the product actually makes its contribution to revenue. Thus, expense recognition is tied to revenue recognition. This practice is referred to as the matching principle because it dictates that efforts (expenses) be matched with the revenues whenever it is reasonable and practicable to do so.

### 2.3.4 The Objective Principle

Accounting records and statements are based on the most reliable data availa-

ble so that they will be as accurate and as useful as possible. This guideline is the objective principle. The key of objective principle is that accounting records and financial reports must be based on financial and economic transactions as they actually take place, in order to reflect the financial position and operating results of an enterprise objectively. Without the objective principle, accounting records would be based on whims and options and subject to dispute.

### **2.3.5 The Full Disclosure Principle**

The full disclosure principle holds that a company's financial statement should report enough information for outsiders to make knowledgeable decision about the company. In short, the company should report relevant, reliable, and comparable information about its economic affairs. Adequate disclosure can be accomplished either in the financial statements or in the notes accompanying the statements. Such disclosure should make the financial statements more useful and less subject to misinterpretation. The key point to bear in mind is that the supplementary information should be relevant to the interpretation of the financial statements.

### **2.3.6 The Materiality Principle**

In following general accepted accounting principles, accountants must consider the relative importance of any transactions. Accountants are primarily concerned with significant information and not overly concerned with those items which have little effect on financial statements. However, to determine whether the materiality of a transaction is or not, no precise criteria can be formulated. Accountants are required to judge the materiality in accounting practice. An item is judged to be material if it is important enough to influence the decisions of statement users. Materiality of an item may depend not only on its amount but also on its nature.

### **2.3.7 The Consistency Principle**

The principle of consistency implies that accounting methods should be consistent from one period to the other and should not be arbitrarily changed. Changes



and reasons for changes, if necessary, and their impact on an enterprise's financial position and operating results, should be reported in notes to the financial statements. This assumption is very important because it assists users of financial statements in interpreting changes in financial position and changes in net income.

### 2.3.8 Conservatism Principle

Conservatism holds that accountants should be conservative in their selection of procedures—valuation of assets and determination of revenues, choosing those that is lower among several alternatives. It means: **when in doubt choose the solution that will be least likely to overstate assets and income.** The financial positions can be presented reasonably and the income amount be calculated correctly if the principle of conservatism is applied properly.

## Applying the Cost Principle

### Applying Your Knowledge

You are considering the purchase of land for future expansion. The seller is asking \$50 000 for land that cost him \$35 000. An appraisal shows a value of \$47 000. You first offer \$44 000, the seller makes a counteroffer of \$48 000, and you agree on \$46 000. What dollar value should be reported for the land on your financial statements?

According to the cost principle, assets and services should be recorded at their actual cost. You report the land at \$46 000, which is its historical cost. Because it is the value that you pay actually for the land.

## Key words, phrases, and special terms

accounting standard

会计规范

accounting assumptions

会计假设

accounting entity	会计主体
going concern	持续经营
monetary unit	货币计量
accounting period	会计分期
cash- basis	现金收付制
accrual- basis	权责发生制(应计制)
cost principle	成本原则
realization principle	实现原则
matching principle	配比原则
objective principle	客观性原则
consistency principle	一致性原则
full disclosure	充分反映
materiality	重要性
conservatism	稳健性

### Multiple-choice questions

1. GAAP are very important to ( ).

- a. managers
- b. auditors
- c. investors
- d. accountants

2. All goods and service purchased are recorded at acquisition cost in order to meet the requirement of ( ).

- a. objectivity principle
- b. cost principle
- c. continuing concern concept
- d. time period assumption

3. ( ) has the assumption that the business will continue in operation.

- a. Objectivity principle

- b. Accounting entity
  - c. Continuing concern
  - d. Accounting periods
4. Under (     ), the accountants must consider the relative importance of any event.
- a. objectivity principle
  - b. continuing concern
  - c. cost principle
  - d. materiality principle
5. (     ) implies the stability of money such as U. S. dollar.
- a. Cost principle
  - b. Accounting entity
  - c. Monetary measurement
  - d. Objectivity principle
6. If the going-concern assumption is no longer valid for a company, (     ).
- a. land held as an investment would be valued at its liquidation value
  - b. all prepaid assets would be completely written off immediately
  - c. total contributed capital and retained earnings would remain unchanged
  - d. the allowance for uncollectible accounts would be eliminated
7. Which accounting concept or principle specifically states that we should record transactions at amounts that can be verified? (     ).
- a. Entity concept
  - b. Reliability principle
  - c. Cost principle
  - d. Going-concern concept

## Exercises

*(Applying accounting concepts and principles)*

1. Dell Computer began in Michael Dell's dorm room at The University of Texas at Austin. Suppose Dell kept a single checkbook to account for both his personal affairs and Dell Computer transactions. Would he be able to determine the success or failure of the business? Which accounting concept or principle is applicable to Dell's situation?

2. Dell Computer owns real estate around Austin, Texas. Suppose the company purchased land for \$3 million in 1995, and its value has risen. The business is offering the land for sale. One real estate appraiser says the land is worth \$10 million; another appraises the land at \$15 million. Should Dell record a gain on the value of the land, or should Dell wait to record the gain after it has actually sold the land? Which accounting concept or principle controls this situation?

3. Dell Computer has several divisions. Managers of each division are evaluated on their division's profit performance. Which concept or principle helps Dell Computer design an accounting system to identify the most profitable division managers?

4. Suppose Dell Computer decides to get out of the magnetic imaging business and offers its magnetic imaging division for sale. Which accounting concept or principle helps Dell account for its magnetic imaging division differently from its main operations?

5. Dell Computer must pay for the materials, labor, and overhead inputs to its computers. After assembly, a computer is much more valuable than the sum of the inputs. Which accounting concept or principle provides guidance on how to account for the materials, labor and overhead?

## Cases

1. You are a professional accountant working for a public accounting firm and find yourself in a difficult situation. You have discovered some irregularities in the financial records of your firm's client. You are uncertain whether these irregularities are the result of carelessness on the part of the company's employees or repre-

sent intentional steps taken to cover up questionable activities. You approach your superior about this and she indicates that you should ignore it. Her response is “These things happen all of the time and usually are pretty minor. We are on a very tight time schedule to complete this engagement, so let’s just keep our eyes on our goal of finishing our work by the end of the month.”

What would you do?

2. At December 30, 2008, Ham Software Inc. , purchased a computer system from a mail- order supplier for \$ 14 000. The retail value of the system- according to the mail- order supplier- was \$ 20 000. On January 7, however, the system was stolen during a burglary. In its December 31, 2008, balance sheet, Ham showed this computer system at \$ 14 000 and made no reference to its retail value or to the burglary. The December balance sheet was issued in February of 2009.

In this case, indicate the appropriate balance sheet amount of the asset under GAAP. If the amount assigned by the company is correct or not, briefly explain the accounting principle that justify or violated this amount.

# CHAPTER 3

## Accounting Equation

—*Why All Accounts are Always Balance*

The most basic tool of accounting is the accounting equation. The equation presents the resources of the business and the claims to those resources. The financial statements, as the final product of the accounting process, are prepared based on this equation.

### 3.1 The Accounting Elements

Before the accounting process can begin, the organization must be defined. A business entity could be an individual, association, or other organization that engages in business activities. This definition separates personal from business finances of an owner.

A business that is owned by one person is called a proprietorship. The owner of the business is known as the proprietor. Here, we will only discuss proprietorship.

The three basic accounting elements are assets, liabilities, and owner's equity. They exist in every business entity.

#### **Assets**

An item of value that is owned and will provide future benefits is called an asset. Such items include cash, office supplies, office equipment and land. Another type of asset is an account receivable.

This is an unwritten promise by a customer to pay for services rendered.

#### **Liabilities**

A liability is an amount owed to another business. Liabilities are usually paid in cash.

The most common liability is accounts payable. An account payable is an unwritten promise to pay at a later date.

### **Owner's Equity**

The amount by which business assets exceed business liabilities is called owner's equity. If there are no liabilities, the owner's equity is equal to the total amount of the assets. Owner's equity is increased with revenue, and decreased by expenses or an owner's withdrawal.

### **Revenue**

Revenue is the economic resources flowing into a business as a result of rendering goods sold and services during a given accounting period. Sales revenue, service revenue, and investment revenue are subdivisions of revenue. Increase in revenue will increase owner's equity.

### **Expenses**

Expenses are the outflow of a business's economic resources resulting from earning revenue or the cost of the operational activities for the business. Expenses include cost of goods sold, administrative expenses, selling expenses, and financial expenses. Increase in expenses will decrease owner's equity.

### **Net Income**

Net income (or net loss) is the result of matching revenue with expenses. When revenue exceeds expenses, net income occurs, otherwise net loss occurs. The earning of net income, or profits, is a major goal of almost every enterprise, larger or small.

## **3.2 The Accounting Equation**

The relationship between the three basic accounting elements—assets, liabilities, and owner's equity—is expressed in the accounting equation, shown as follows:

$$\begin{array}{c}
 \text{Assets} = \text{Equities} \\
 \text{Assets} = \text{Creditors} + \text{Owner} \\
 \text{Assets} = \text{Liabilities} + \text{Owner's Equity}
 \end{array}$$

This equation shows assets are equal to equities. Equities are divided into liabilities and owner's equity. When the amounts of any two of these elements (assets, liabilities, or owner's equity) are known, the third can be calculated. The following are variations of the accounting equation:

$$\begin{array}{rcl}
 \text{Owner's Equity} & = & \text{Assets} - \text{Liabilities} \\
 \text{Liabilities} & = & \text{Assets} - \text{Owner's Equity} \\
 \text{Liabilities} + \text{Owner's Equity} & = & \text{Assets}
 \end{array}$$

### 3.3 The Effects of Transaction on the Accounting Equation

Any activity of a business which affects the accounting equation is a **transaction**. Transactions are recorded in the accounting records using the **cost principle**. The actual amount paid or received is the amount recorded. Buying and selling assets, performing service and borrowing money are common business transactions.

#### 3.3.1 The Basic Accounting Equation: Assets=Liabilities+Owner's Equity

The effect of any transaction on the accounting equation may be indicated by increasing or decreasing a special asset, liability or owner's equity element. To illustrate, assume the following transactions took place during January, 2015, for Ted Andy, Dentist. The effect of these transactions on the accounting equation can be analyzed as follows:

**Transaction (1): owner invested \$ 50 000 cash in the business**

**Effect on Accounting Equation:**

An increase in an asset offset by an increase in owner's equity.

**Analysis:**

Andy opened a bank account for his business with a deposit of \$ 50 000. This



transaction increased the asset Cash. Since Andy contributed the asset, owner's equity—Ted Andy, Capital—was increased by the same amount. The equation for the business would appear as follows:

<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash	=			Ted Andy, Capital
(1) + \$ 50 000				+ \$ 50 000

Total Assets: \$ 50 000=Total Liabilities+Owner's Equity: \$ 50 000.

**Transaction (2):purchased office equipment on account, \$ 2 500**

**Effect on Accounting Equation:**

An increase in an asset offset by an increase in a liability.

**Analysis:**

Andy purchased office equipment (desks, chairs, file cabinet, etc. )for \$ 2 500 on account. This transaction caused the asset Office Equipment to increase by \$ 2 500. The liability Account Payable increased by the same amount. There was no effect on the owner's equity. The accounting equation now looks like this:

	<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
	Cash	+ Office Equipment	=	Accounts Payable		Ted Andy, Capital
	\$ 50 000					\$ 50 000
(2)		+2 500		+2 500		
	\$ 50 000	+ 2 500	=	\$ 2 500	+	\$ 50 000

Total Assets: \$ 52 500=Total Liabilities+Owner's Equity: \$ 52 500.

**Transaction (3):purchased office supplies for cash, \$ 350**

**Effect on Accounting Equation:**

An increase in one asset offset by a decrease in another asset.

**Analysis:**

Andy purchased office supplies (stationery, legal pads, pencils, etc. )for cash, \$ 350. This transaction caused a \$ 350 decrease in the asset Cash. The asset Office Supplies increased by \$ 350. The effect on the equation is as follows:

<u>Assets</u>				=	<u>Liabilities</u>	+	<u>Owner's Equity</u>	
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	Ted Andy, Capital	
\$ 50 000				\$ 2 500		\$ 2 500	\$ 50 000	
(3) <u>-350</u>		<u>+350</u>						
<u>\$ 49 650</u>	+	<u>\$ 350</u>	+	\$ 2 500	=	\$ 2 500	+	\$ 50 000

Total Assets: \$ 52 500=Total Liabilities+Owner's Equity: \$ 52 500.

**Transaction (4):paid amount owed to a creditor, \$ 500**

**Effect on Accounting Equation:**

A decrease in an asset offset by a decrease in a liability.

**Analysis:**

Andy paid \$ 500 on account to the company from which the office equipment was purchased. Earlier, Andy purchased office equipment on account. The office equipment account increased and the liability Accounts Payable increased. Now Andy is going to make a payment on this account. This payment caused both the asset Cash and the liability Accounts Payable to decrease by \$ 500. The effect on the equation is as follows:

	Assets				=	Liabilities	+	Owner's Equity	
	Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	Ted Andy, Capital	
	\$ 49 650		\$ 350		\$ 2 500		\$ 2 500	\$ 50 000	
(4)	<u>-500</u>						<u>-500</u>		
	\$ 49 150	+	\$ 350	+	\$ 2 500	=	\$ 2 000	+	\$ 50 000

Total Assets: \$ 52 000=Total Liabilities+Owner's Equity: \$ 52 000.

**Transaction (5):purchased office supplies on account, \$ 400**

**Effect on Accounting Equation:**

An increase in an asset offset by an increase in a liability.

**Analysis:**

Andy purchased office supplies on account for \$ 400. This transaction caused the asset Office Supplies to increase by \$ 400 and increase the liability Account

Payable by the same amount. The effect of this transaction on the equation is as follows:

<u>Assets</u>					=	<u>Liabilities</u>	+	<u>Owner's Equity</u>
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable		Ted Andy, Capital
\$ 49 150		\$ 350		\$ 2 500		\$ 2 000		\$ 50 000
(5) _____		<u>+400</u>		_____		<u>+400</u>		_____
\$ 49 150	+	\$ 750	+	\$ 2 500	=	\$ 2 400	+	\$ 50 000

Total Assets: \$ 52 400=Total Liabilities+Owner's Equity: \$ 52 400.

3.3.2 Expanding the Accounting Equation: Revenues—Expenses=Net Income

To complete our discussion of the accounting equation, three additional items must be covered: revenue, expense and owner's withdrawal.

The term revenue generally means an increase in assets because a service was rendered. Revenue is one of two ways that owner's equity can be increased:

(1) As illustrated in transaction (1), the owner may invest cash. Such an investment increases both assets and owner's equity.

(2) Revenue earned from providing services to customers also increases owner's equity.

When **revenue** is earned, the assets are increased (normally cash or accounts receivable), and owner's equity is increased.

The term **expense** generally means a decrease in assets (usually cash) or an increase in liabilities (usually accounts payable) in order to earn more revenue. Just like revenue, an expense directly affects the owner's equity and is one of the two ways that owner's equity can be decreased:

(1) The owner may withdraw cash or other assets from the business. This type of transaction is charged to the owner's drawing account.

(2) Expense incurred in operating the business also decrease owner's equity.

Common examples of expenses are office rent, salaries of employees, telephone service, and many types of taxes.

If total revenue of the period exceeds total expenses, the result is called **net in-**

**come.** On the other hand, if total expense of the period exceeds total revenue, the result is called **net loss**.

The time period covered for a business may be a month, a year, or some other period of time. Any accounting period of twelve months' duration is called a **fiscal year**. The fiscal year can also be a calendar year.

**3.3.3 Effect of Revenue, Expense, and Owner's Withdrawal Transaction on the Accounting Equation**

To show the effect of revenue, expense, and owner's withdrawal, the example of Ted Andy, Dentist, will be continued.

**Transaction (6): owner withdrew \$ 300 for personal use**

**Effect on Accounting Equation:**

A decrease in an asset offset by a decrease in owner's Equity.

**Analysis:**

Andy withdraw cash in the amount of \$ 300 from the business for his personal use. This transaction resulted in a decrease to the asset Cash and a decrease to owner's equity. Owner's equity decreased because of a personal withdraw of cash by the owner. A withdrawal, or the use of the term **drawing**, is used to indicate a personal expense and not a business expense. The effect of this transaction on the equation is as follows:

Assets				=	Liabilities	+	Owner's Equity							
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	+	Capital Ted Andy, Capital	-	Drawing Ted Andy Drawing	+	Revenue	-	Expense
\$ 49 150		\$ 750		\$ 2 500		\$ 2 400		\$ 50 000						
(6) —300										+300				
\$ 48 850	+	\$ 750	+	\$ 2 500	=	\$ 2 400	+	\$ 50 000	-	\$ 300				

Total Assets: \$ 52 100 = Total Liabilities + Owner's Equity: \$ 52 100.  
(Notice that owner's drawing decreases total owner's equity by \$ 300.)

**Transaction (7): received cash as payment for professional fees, \$ 3 500**

**Effect on Accounting Equation:**

An increase in an asset offset by an increase in owner's equity.

**Analysis:**

Andy received \$ 3 500 cash from a client for dental services performed. This transaction caused the asset Cash to increase by \$ 3 500. Since cash was received for services performed, owner's equity also increased. Professional Fees is the account title used for revenue. The effect of this transaction on the equation is as follows:

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Assets				=	Liabilities	+	Owner's Equity							
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	+	Capital Ted Andy, Capital	-	Drawing Ted Andy Drawing	+	Revenue	-	Expense
\$ 48 850		\$ 750		\$ 2 500		\$ 2 400		\$ 50 000		\$ 300				
(7) +3 500												+3 500		
\$ 52 350	+	\$ 750	+	\$ 2 500	=	\$ 2 400	+	\$ 50 000	-	\$ 300	+	\$ 3 500		

Total Assets: \$ 55 600=Total Liabilities+Owner's Equity: \$ 55 600.

Transaction (8):paid office rent \$ 1 000

Effect on Accounting Equation:

A decrease in an asset offset by a decrease in owner's equity.

Analysis:

Andy paid \$ 1 000 for office rent for January. This transaction caused the asset Cash to decrease by \$ 1 000, with an equal reduction in owner's equity. Owner's equity was decreased because of rent expense. The effect of this transaction on the equation is as follows:

Assets				=	Liabilities	+	Owner's Equity							
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	+	Capital Ted Andy, Capital	-	Drawing Ted Andy Drawing	+	Revenue	-	Expenses
\$ 52 350		\$ 750		\$ 2 500		\$ 2 400		\$ 50 000		\$ 300		\$ 3 500		
(8) -1 000														+1 000
\$ 51 350	+	\$ 750	+	\$ 2 500	=	\$ 2 400	+	\$ 50 000	-	\$ 300	+	\$ 3 500	-	\$ 1 000

Total Assets: \$ 54 600=Total Liabilities+Owner's Equity: \$ 54 600.

(Notice that even though \$ 1 000 is added to expenses, there is a minus sign in front of expenses in the equation, which means that expenses decrease owner's equity. )

Transaction (9):paid telephone expense, \$ 75

Effect on Accounting Equation:

A decrease in an asset offset by a decrease in owner's equity.

Analysis:

Andy paid a bill for telephone service, \$ 75. This transaction, like the previous one, decreased the asset Cash, and also decreased owner's equity. Owner's equity was decreased because of the Telephone Expense. The effect of this transaction on the equation is as follows:

Assets				=	Liabilities	+	Owner's Equity							
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	+	Capital Ted Andy, Capital	-	Drawing Ted Andy Drawing	+	Revenue	-	Expense
\$ 51 350		\$ 750		\$ 2 500		\$ 2 400		\$ 50 000		\$ 300		\$ 3 500		\$ 1 000
(9) <u>-75</u>														<u>+75</u>
\$ 51 275	+	\$ 750	+	\$ 2 500	=	\$ 2 400	+	\$ 50 000	-	\$ 300	+	\$ 3 500	-	\$ 1 075

Total Assets: \$ 54 525=Total Liabilities+Owner's Equity: \$ 54 525.

From the above analysis, we know that every business transaction, no matter how simple or how complex, can be expressed in terms of its effect on the accounting equation. Each business transaction makes at least two effects on the accounting equation that always keeps balance after every Business transaction was finished, i. e. , the total amount of left side equals to that of the right side.

Applying the Accounting Equation

Applying Your Knowledge

Mark Corporation begins the year, if the assets are \$ 174 300 and the liabilities are \$ 82 000, how much is the owners' equity?

If the owners' equity in the business increased \$ 10 000 and the liabilities decreased \$ 5 000 in this year, how much are the assets?

If the company reported yearly revenues of \$ 77 600 and assets of \$ 210 000 at the end of this period. The other items have no change. What is expenses and how

much are **The result of operations** for the period?

We can apply **the accounting equation** to determine the amounts of all the above items:

$$(1) \text{The owners' equity} = \$92\,300 \quad (\$174\,300 - \$82\,000)$$

$$(2) \text{The assets} = \$179\,300 \quad (\$92\,300 + \$10\,000 + \$82\,000 - \$5\,000)$$

$$(3) \text{The expense} = \$46\,900 \quad [\$77\,600 - (\$210\,000 - \$179\,300)]$$

$$\text{The result of operations (Net income)} = \$30\,700 \quad (\$77\,600 - \$46\,900).$$

### Key words, phrases, and special terms

asset

资产

liability

负债

owner's equity

所有者权益

accounting equation

会计平衡公式

fiscal year

会计年度

transaction

交易, 业务

basic accounting elements

基本会计要素

drawing

提款, 资本撤回

net income

净利润

net loss

净损失

expense

费用

revenue

收入

### Multiple-choice questions

1. Suppose a Target store has cash of \$50 000, receivables of \$60 000, and furniture and fixture totaling \$200 000. The store owes \$80 000 on account and has a \$100 000 note payable. How much is the store's owner equity? ( ).

a. \$20 000

b. \$310 000



- c. \$ 180 000
- d. \$ 130 000

2. Carolina Corporation begins the year with retained earnings of \$100 000. During the year, the corporation earns \$40 000 and declares dividends of \$15 000.

**Carolina Corporation**

**Change in retained earnings**

Beginning Retained Earnings	\$ 100 000
Add: Income	_____
Less: Dividends Declared	_____
Ending Retained Earning	_____

Carolina should report ending retained earnings of ( ).

- a. \$ 100 000
- b. \$ 115 000
- c. \$ 125 000
- d. \$ 140 000
- e. \$ 150 000

3. Portions of Home Company’s balance sheet were damaged by spilled coffee. Using your knowledge of balance sheet relationships, calculate the ending Capital Stock account balance.

**Home Company**

**Balance sheet at December 31, 20×5**

Assets		Liabilities	
Cash	\$ 40 000	Accounts Payable	\$ 60 000
Inventory	100 000	Capital Stock	?
Investments	100 000	Retained Earning	80 000
	\$ 240 000		\$ ?

The balance in the Capital Stock account is ( ).

- a. \$ 80 000
- b. \$ 100 000
- c. \$ 120 000

d. \$ 150 000

e. \$ 180 000

4. All of Associated Company's balance sheet accounts except cash are shown here:

**Associated Company**

**Balance sheet items at December 31, 20×3**

Expenses Payable	\$ 20 000
Retained Earnings	230 000
Inventory	10 000
Equipment	80 000
Capital Stock	110 000
Note Payable	40 000
Factory	230 000

For this exercise, first classify the accounts as assets, liabilities, or owners' equity. Then use the balance sheet equation to calculate the missing amounts.

Associated's cash balance is( ).

a. \$ 40 000

b. \$ 50 000

c. \$ 70 000

d. \$ 80 000

e. \$ 100 000

5. This exercise involves recognition of asset, liability, and owners' equity accounts. Hillside Company's balance sheet at the beginning of 20×6 shows the following:

Cash	\$ 500
Capital Stock	100
Accounts Receivable	48
Accumulated Depreciation	90
Accounts Payable	30
Inventory	10

Retained Earning 528

Equipment 190

Hillside’s assets (net of accumulated depreciation) on January 1, 20×6 total ( ).

- a. \$ 621
- b. \$ 658
- c. \$ 660
- d. \$ 710
- e. \$ 719

6. Dalmatian Corporation begins the year with \$ 200 000 of retained earnings. During the year, the corporation earns \$ 60 000. Ending retained earnings are \$ 220 000.

**Dalmatian Corporation**  
**Change in retained earnings**

Beginning Retained Earnings	\$ 200 000
Add: Income	_____
Less: Dividends Declared	_____
Ending Retained Earnings	\$ 220 000

The corporation declared the following dividends to Sandra, Sally, and Susie, the three shareholders: ( ).

- a. \$ 20 000
- b. \$ 40 000
- c. \$ 60 000
- d. \$ 80 000
- e. \$ 90 000

7. If Fossil paid expenses totaling \$ 35 000. How does this transaction affect Fossil’s accounting equation? ( ).

- a. Increases assets and decreases liabilities
- b. Increases both assets and owner’s equity
- c. Decreases both assets and owner’s equity

d. Decreases assets and increases liabilities

### Exercises

1. Answer these questions about two actual companies.

(1) The Gap Co. began the year with total liabilities of \$1.8 billion and total stockholders' equity of \$1.6 billion. During the year, total assets increased by 16.6%. How much are total assets at the end of the year?

(2) Johnson & Johnson, famous for Band-Aids and other health-care products, began the year with total assets of \$12.2 billion and total liabilities of \$6.7 billion. Net income for the year was \$2.0 billion, and dividends and other decreases in stockholders' equity totaled \$0.4 billion. How much is stockholders' equity at the end of the year?

2. On January 1, 200×, Mickey McCrea, a certified public accountant, had assets consisting of: cash, \$15 000; office equipment, \$8 000; and an automobile, \$22 000. Accounts payable was \$12 800. The following business transactions occurred during the month of January.

- a. Paid \$400 cash for office equipment
- b. Paid office rent for January, \$1 100
- c. Received \$4 400 cash for professional services
- d. Paid for telephone service, \$210
- e. Paid \$3 800 on the account payable
- f. Withdrew \$900 for personal use

Required:

Calculate the beginning balance for capital and indicate the effect of each transaction on the accounting equation by using the form shown below. Each amount should be preceded by a plus sign if it represents an increase or by a minus sign if it represents a decrease. Calculate the balance in each account after each transaction has been entered to verify that the accounting equation is in balance.

Assets	=	Liabilities	+	Owner's Equity
--------	---	-------------	---	----------------

	Cash	+	Office Equip.	+	Automobiles	=	Accounts Payable	+	Capital	-	Drawing	+	Revenue	-	Expense
Bal.	\$ 15 000	+	\$ 8 000	+	\$ 22 000	=	\$ 12 800								
a.	_____		_____		_____		_____		_____		_____		_____		_____
b.	_____		_____		_____		_____		_____		_____		_____		_____
c.	_____		_____		_____		_____		_____		_____		_____		_____
d.	_____		_____		_____		_____		_____		_____		_____		_____
e.	_____		_____		_____		_____		_____		_____		_____		_____
f.	_____		_____		_____		_____		_____		_____		_____		_____

3. Complete the following chart concerning increases and decreases in the accounting elements.

	Recorded on Debit Side	Recorded on Credit Side
a. Increase in cash account	_____	_____
b. Decrease in accounts payable account	_____	_____
c. Increase in owner's capital account	_____	_____
d. Increase in owner's drawing account	_____	_____
e. Increase in expense account	_____	_____
f. Increase in revenue account	_____	_____
g. Increase in accounts payable account	_____	_____

4. During the month of April, Macon Co. had cash receipts from customers of \$ 79 000, Expenses totaled \$ 52 000, and accrual basis net income was \$ 14 000. There were no gains or losses during the month.

Required:

- a. Calculate the revenues for Macon Co. for April.
  - b. Explain why cash receipts from customers can be different from revenues.
5. Indicate the effect of each of the following transactions on total assets, total liabilities, and total owner's equity. Use (+) for increase, (−) for decrease, and (NE) for no effect. The first transaction is provided as an illustration.

	Assets	Liabilities	Owner's Equity
a. Borrowed cash on a bank loan .....	+	+	NE
b. Paid an account payable .....			
c. Sold common stock .....			
d. Purchased merchandise inventory on account ...			
e. Declared and paid dividends .....			
f. Collected an account receivable .....			
g. Sold merchandise inventory on account at a profit ...			
h. Paid operating expenses in cash .....			
i. Repaid principal and interest on a bank loan .....			

Cases

1. Contact a local business and arrange with the owner to learn what accounts the business uses.

Required:

- (1) Obtained a copy of the business's chart of accounts.
- (2) Prepare the company's financial statements for the most recent month, quarter, or year.

You may use either made-up account balances or balances supplied by the owner.

If the business has a large number of accounts within a category, combine related accounts and report a single amount on the financial statements. For example, the company may have several cash accounts. Combine all cash amounts and report a single Cash amount on the balance sheet.

You will probably encounter numerous accounts that you have not yet learned. Deal with these as best as you can.

Keep in mind that the financial statements report the balances of the accounts listed in the company's chart of accounts. Therefore, the financial statements must

be consistent with the chart of accounts.

2. Assume you are out of school for the summer and decide to begin a small business to make money to help cover the cost of school next year and to have spending money this summer. You decide to establish a lawn care service. What assets would you expect to need to start and maintain your business? Assuming you are successful in getting the business started, what revenues and expenses would you expect to incur as you run your business? How would you know if you were doing well in terms of covering your costs and earning money for school next year?

3. How to use the accounting equation to understand the following questions.

(1) When you deposit money in your bank account, the bank credits your account. Is the bank misusing the word credit in this context? Why does the bank use the term credit to refer to your deposit, and not debit?

(2) Your friend asks, “when revenues increase assets and expenses decrease assets, why are revenues credits and expenses debits and not the other way around?” Explain to your friend why revenues are credits and expenses are debits.

4. Ted, a charitable organization in a city, has a standing agreement with a bank. The agreement allows Ted to overdraw its cash balance at the bank when donations are running low. In the past, Ted managed funds wisely and rarely used this privilege. Jacob Henson has recently become the president of Ted. To expand operations, Henson acquired office equipment and spent large amounts on fund-raising. During Henson's presidency, Ted has maintained a negative bank balance of approximately \$6 000.

**Required:** What is the ethical issue in this situation? State why you approve or disapprove of Henson's management of Ted's funds.