

Chapter 1

Accounting in Action

CHAPTER 1

ACCOUNTING IN ACTION

After studying this chapter, you should be able to:

- **1 Explain what accounting is.**
- **2 Identify users and uses of accounting.**
- **3 Understand why ethics is a fundamental business concept.**
- **4 Explain the meaning of generally accepted accounting principles and the cost principle.**

CHAPTER 1

ACCOUNTING IN ACTION

After studying this chapter, you should be able to:

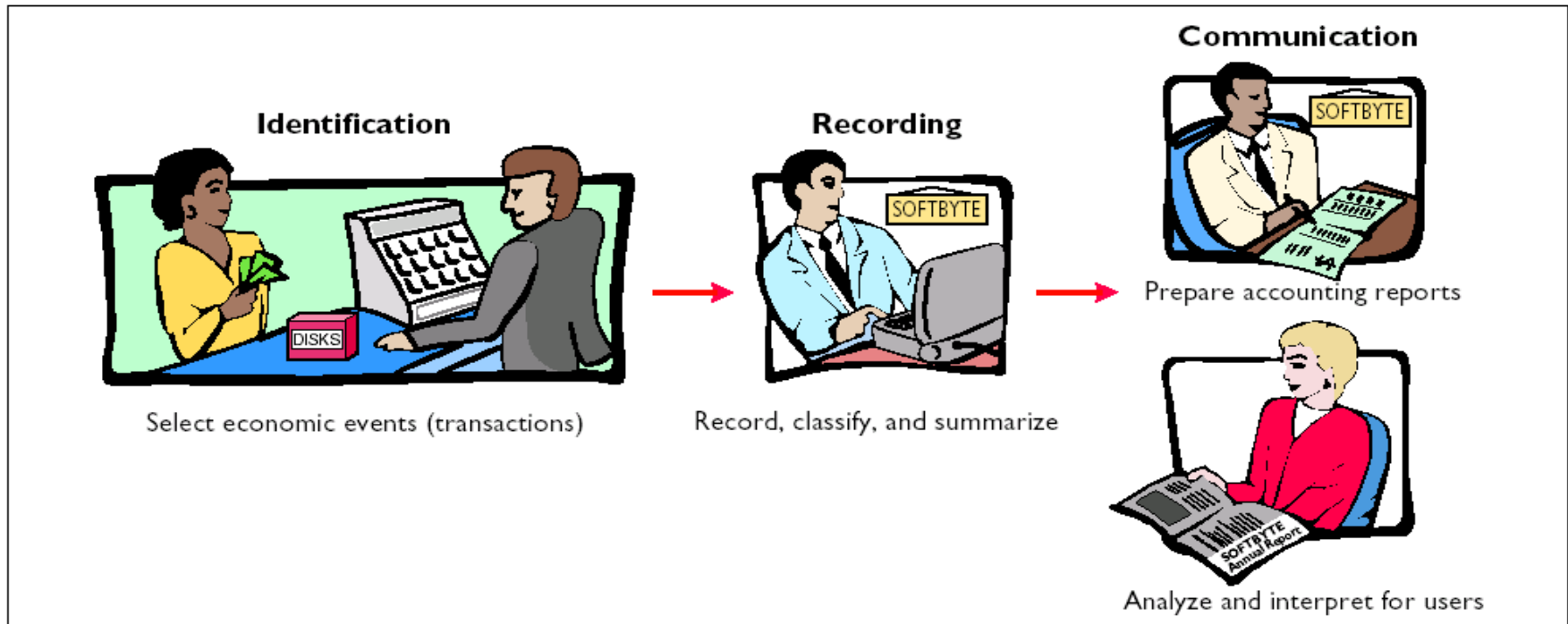
- **5 Explain the meaning of the monetary unit assumption and the economic entity assumption.**
- **6 State the basic accounting equation and explain the meaning of assets, liabilities, and owner's equity.**
- **7 Analyze the effect of business transactions on the basic accounting equation.**
- **8 Understand what the four financial statements are and how they are prepared.**

WHAT IS ACCOUNTING?

STUDY OBJECTIVE 1

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

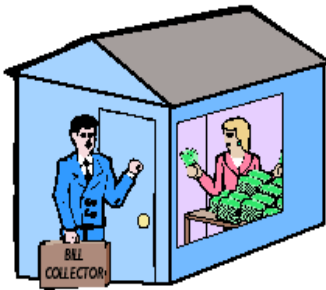
THE ACCOUNTING PROCESS



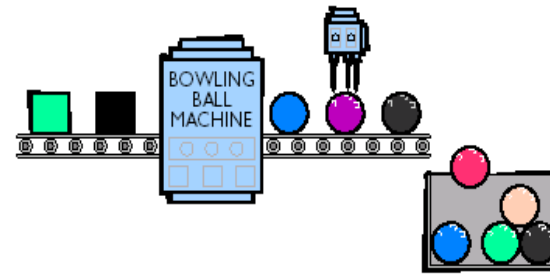
QUESTIONS ASKED BY INTERNAL USERS

STUDY OBJECTIVE 2

Questions Asked by Internal Users



Is cash sufficient to pay bills?



What is the cost of manufacturing each unit of product?



Can we afford to give employee pay raises this year?



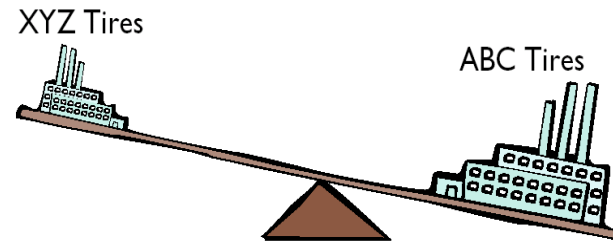
Which product line is the most profitable?

QUESTIONS ASKED BY EXTERNAL USERS

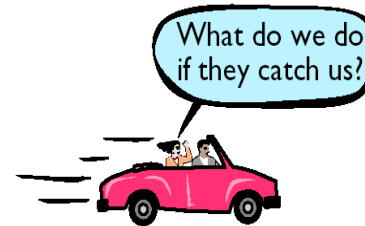
Questions Asked by External Users



Is the company earning satisfactory income?



How does the company compare in size and profitability with competitors?



Will the company be able to pay its debts as they come due?

BOOKKEEPING DISTINGUISHED FROM ACCOUNTING

- **Accounting**

Includes bookkeeping

Also includes much more

- **Bookkeeping**

The recording of economic events

One part of accounting

THE BUILDING BLOCKS OF ACCOUNTING

STUDY OBJECTIVES **3, 4 & 5**

- **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.

The accounting process is correctly sequenced as

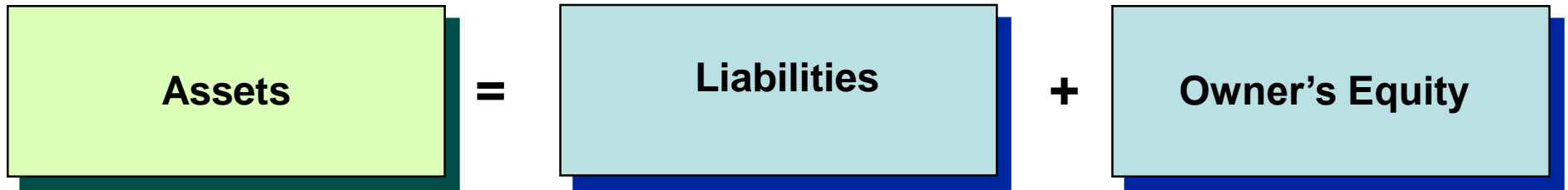
- a. identification, communication, recording.
- b. recording, communication, identification.
- c. identification, recording, communication.
- d. communication, recording, identification.

The accounting process is correctly sequenced as

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

BASIC ACCOUNTING EQUATION

STUDY OBJECTIVE 6



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.

LIABILITIES AS A BUILDING BLOCK

- **Liabilities**

- **are creditor claims against assets**

- **are existing debts and obligations**

OWNER'S EQUITY AS A BUILDING BLOCK

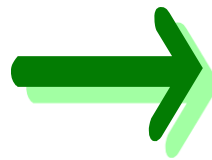
- **Owner's Equity = total assets minus total liabilities. ($A - L = O.E.$)**
- **Owner's Equity represents the **ownership claim** to total assets.**
- **Subdivisions of Owner's Equity:**
 - 1 Capital or Investments by Owner (+)**
 - 2 Drawing (-)**
 - 3 Revenues (+)**
 - 4 Expenses (-)**

INVESTMENTS BY OWNERS AS A BUILDING BLOCK

- **Investments**
 - **are the assets the owner puts in the business**
 - **increase 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



Owner's
Equity



DECREASES



Withdrawals
by Owner

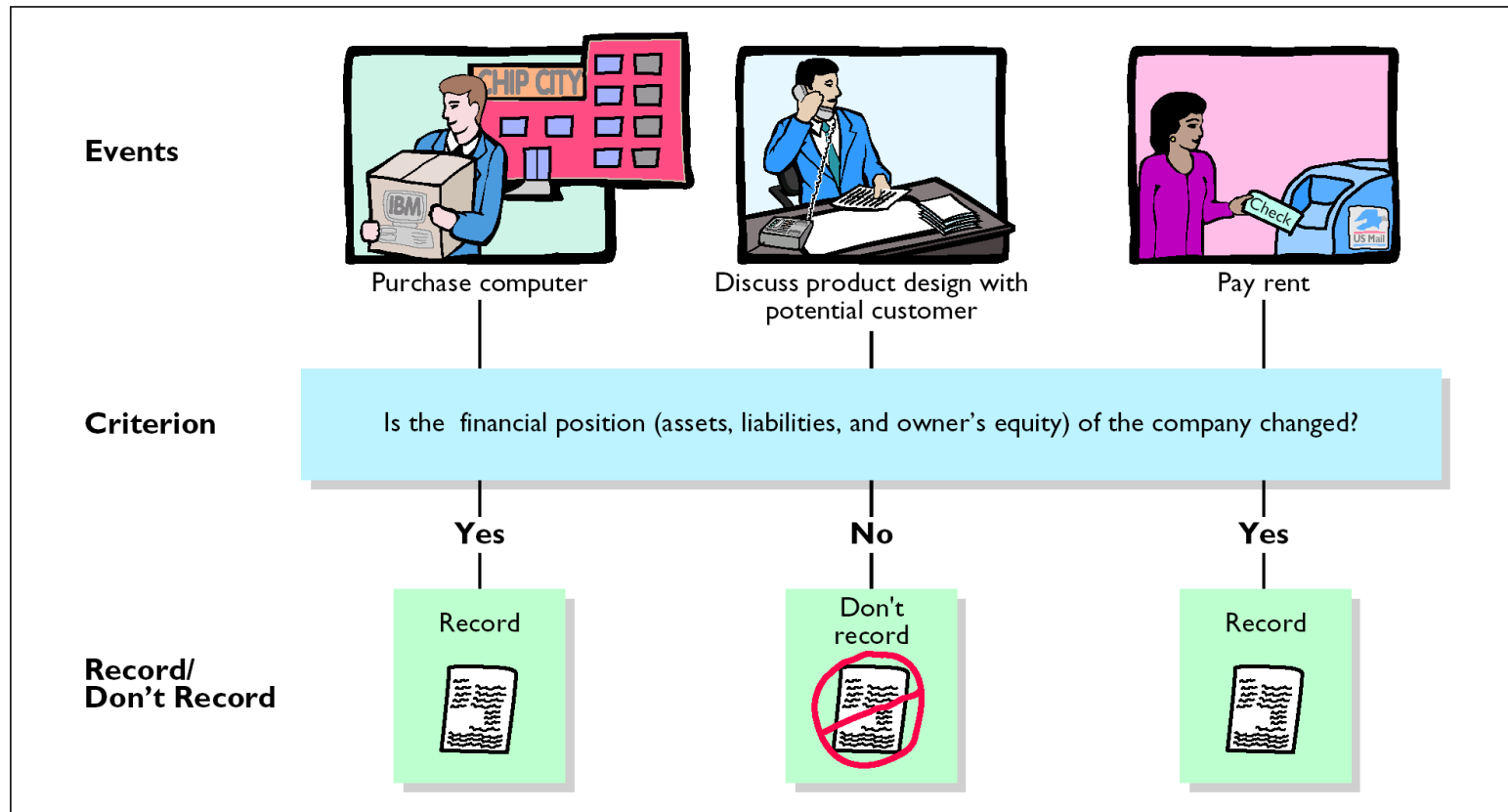
Revenues



Expenses

TRANSACTION IDENTIFICATION PROCESS

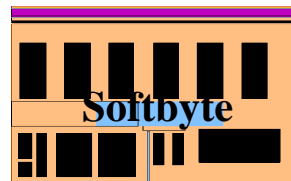
STUDY OBJECTIVE 6



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

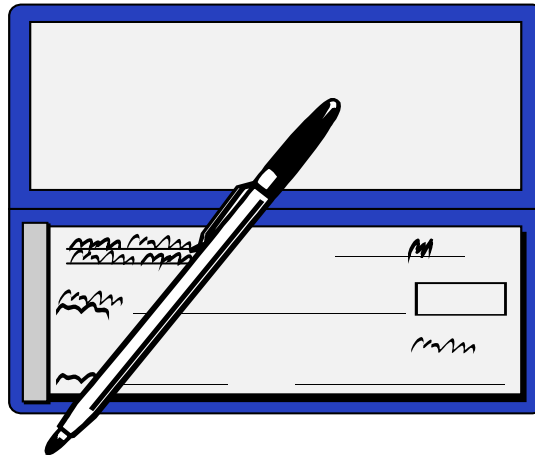
- $$\begin{array}{r} \text{Assets} \\ \hline \text{Cash} \\ \\ + 15,000 \\ \hline \$15,000 \end{array} = \begin{array}{r} \text{Liabilities} \\ \\ \\ \text{Investment} \\ \\ \\ \hline \end{array} + \begin{array}{r} \text{Owner's Equity} \\ \\ \text{R. Neal, Capital} \\ \\ + 15,000 \\ \\ \\ \hline \$15,000 \end{array}$$

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

TRANSACTION ANALYSIS

TRANSACTION 2

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



TRANSACTION ANALYSIS

TRANSACTION 2 SOLUTION

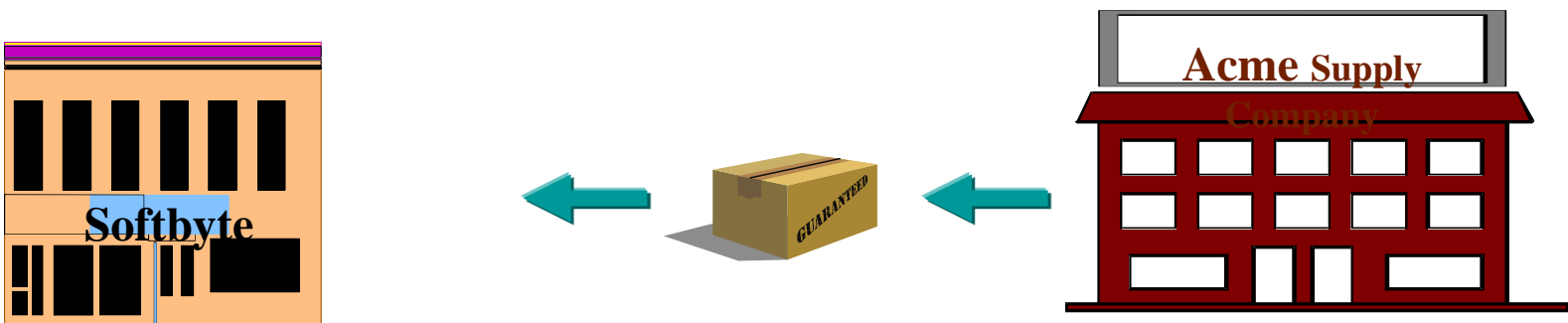
- $$\frac{\text{Assets}}{\text{Cash} + \text{Equipment}} = \frac{\text{Liabilities}}{\text{R. Neal, Capital}} + \frac{\text{Owner's Equity}}{\text{R. Neal, Capital}}$$
- Old
- $$\begin{array}{r} \$15,000 \\ (2) \quad - 7,000 + 7,000 \\ \hline \end{array}$$
- New
- $$\$ 8,000 + \$7,000 = \$15,000$$

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

TRANSACTION ANALYSIS

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

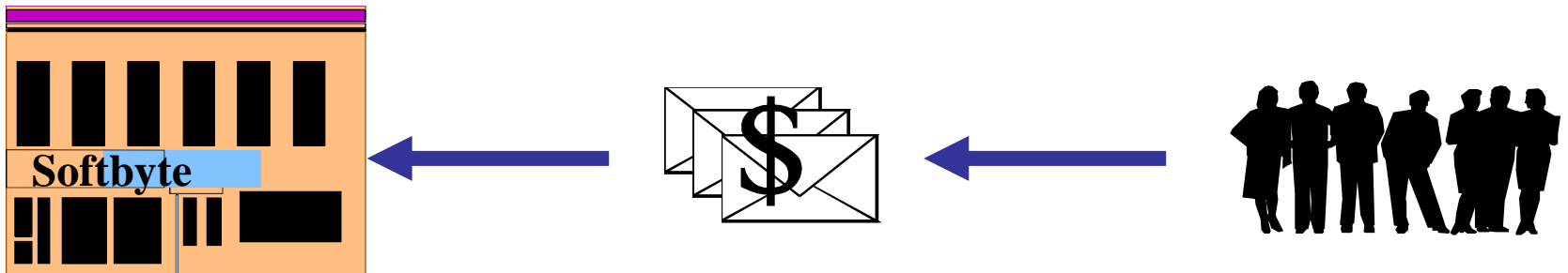
- $$\frac{\text{Assets}}{\text{Cash} + \text{Supplies} + \text{Equip.}} = \frac{\text{Liabilities}}{\text{Accts. Pay.}} + \frac{\text{Owner's Equity}}{\text{R. Neal, Capital}}$$
- Old $\$8,000 + \$7,000 = \$15,000$
- (3) $\frac{\text{Cash} + \$1,600 + \text{Equip.}}{\$8,000 + \$1,600 + \$7,000} = \frac{\text{Accts. Pay.} + \$1,600}{+\$1,600 + \$15,000}$
- New $\$8,000 + \$1,600 + \$7,000 = +\$1,600 + \$15,000$
- $\underbrace{\hspace{10em}}_{\$16,600} = \underbrace{\hspace{10em}}_{\$16,600}$

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

TRANSACTION ANALYSIS

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

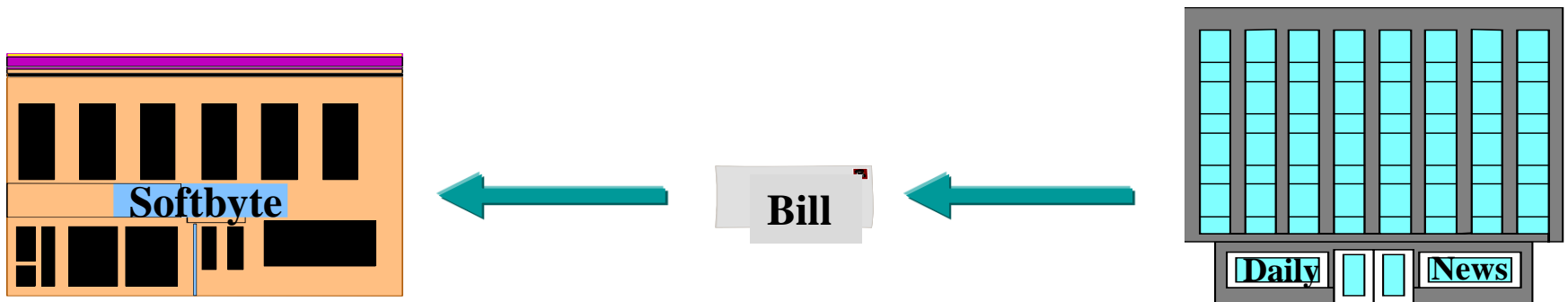
- $$\frac{\text{Assets}}{\text{Cash} + \text{Supplies} + \text{Equip.}} = \frac{\text{Liabilities}}{\text{Accts. Pay.}} + \frac{\text{Owner's Equity}}{\text{R. Neal, Capital}}$$
- Old $\$8,000 + \$1,600 + \$7,000 = \$1,600 + \$15,000$
- (4) $+ 1,200$ $+ 1,200$
- New $\underbrace{\$9,200 + \$1,600 + \$7,000}_{\$17,800} = \underbrace{\$1,600 + \$16,200}_{\$17,800}$
-

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

TRANSACTION ANALYSIS TRANSACTION

5

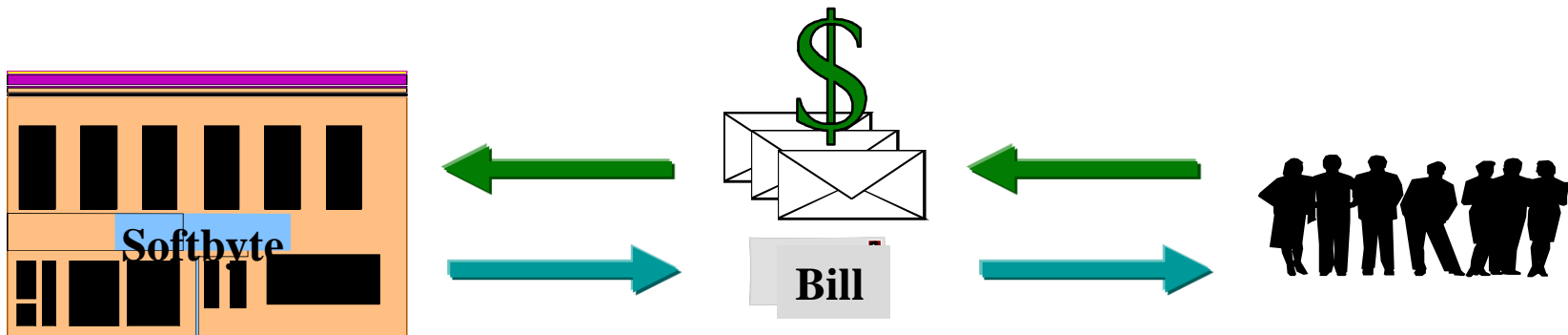
- **Softbyte** receives a bill for **\$250** from the **Daily News** for advertising but postpones payment of the bill until a later date.



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.



TRANSACTION ANALYSIS

TRANSACTION 6 SOLUTION

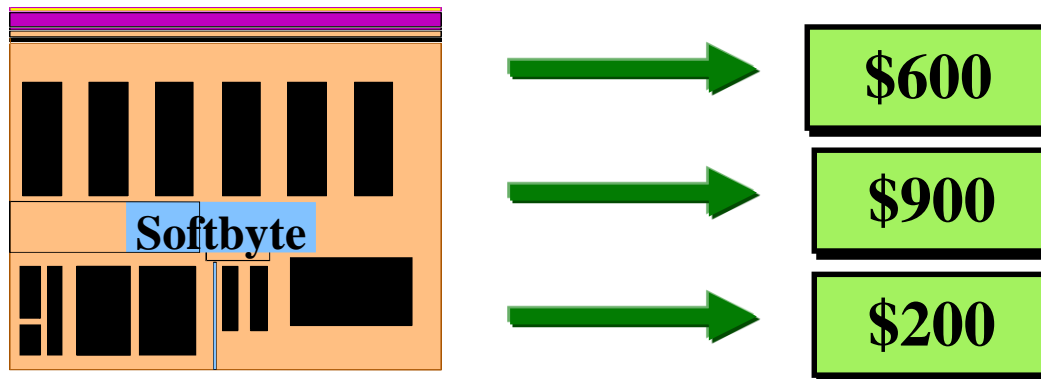
- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$9,200 + \$1,600 + \$7,000 = \$1,850 + \$15,950$$
- (6)
- $$+ \underline{1,500 + 2,000} \qquad \qquad \qquad + \underline{3,500}$$
- New
- $$\underbrace{\$10,700 + \$2,000 + \$1,600 + \$7,000}_{\$21,300} = \underbrace{\$1,850 + \$19,450}_{\$21,300}$$
-

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

- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$10,700 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$19,450$$
- (7)
- $$- 1,700$$
- $$\text{Rent Expense} \quad - \quad 600$$
- $$\text{Salaries Expense} \quad - \quad 900$$
- $$\text{Utilities Expense} \quad - \quad 200$$

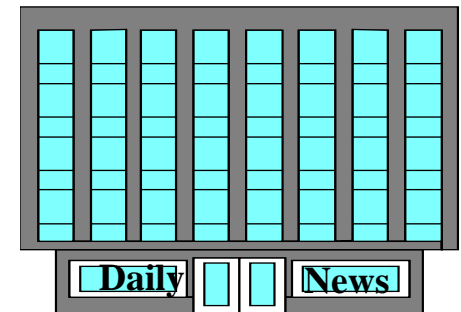
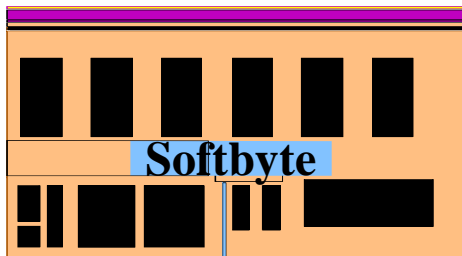
- New
- $$\underbrace{\$9,000 + \$2,000 + \$1,600 + \$7,000}_{\$19,600} = \underbrace{\$1,850 + \$17,750}_{\$19,600}$$

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

TRANSACTION ANALYSIS

TRANSACTION 8

- **Softbyte** pays its **\$250 Daily News** advertising bill in cash.



TRANSACTION ANALYSIS

TRANSACTION 8 SOLUTION

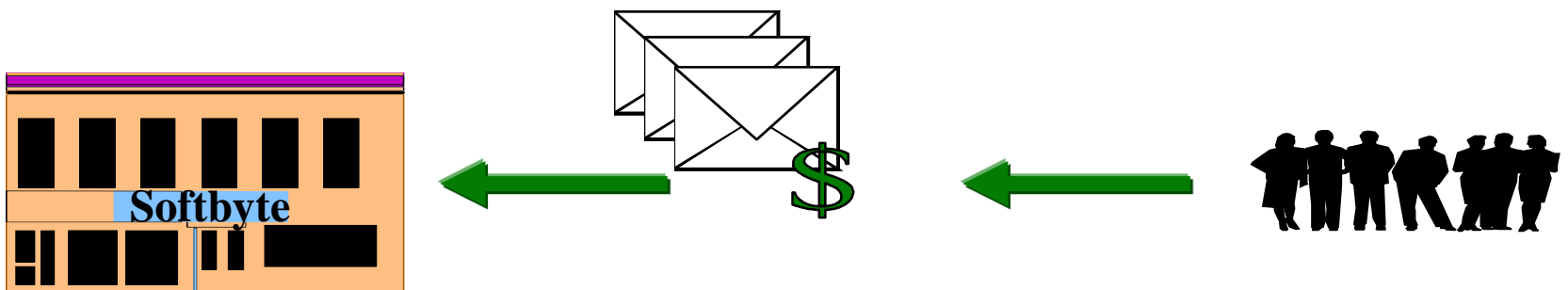
- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$9,000 + \$2,000 + \$1,600 + \$7,000 = \$1,850 + \$17,750$$
- $$(8) - \underline{250} = \underline{- 250}$$
- New
- $$\underbrace{\$8,750 + \$2,000 + \$1,600 + \$7,000}_{\$19,350} = \underbrace{\$1,600 + \$17,750}_{\$19,350}$$
-

Both Cash and Accounts Payable are decreased by \$250. Since the expense was previously recorded, it is not recorded now.

TRANSACTION ANALYSIS

TRANSACTION 9

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



TRANSACTION ANALYSIS

TRANSACTION 9 SOLUTION

- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip.}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$8,750 + \$2,000 + \$1,600 + \$7,000 = \$1,600 + \$17,750$$
- $$(9) + 600 - 600$$

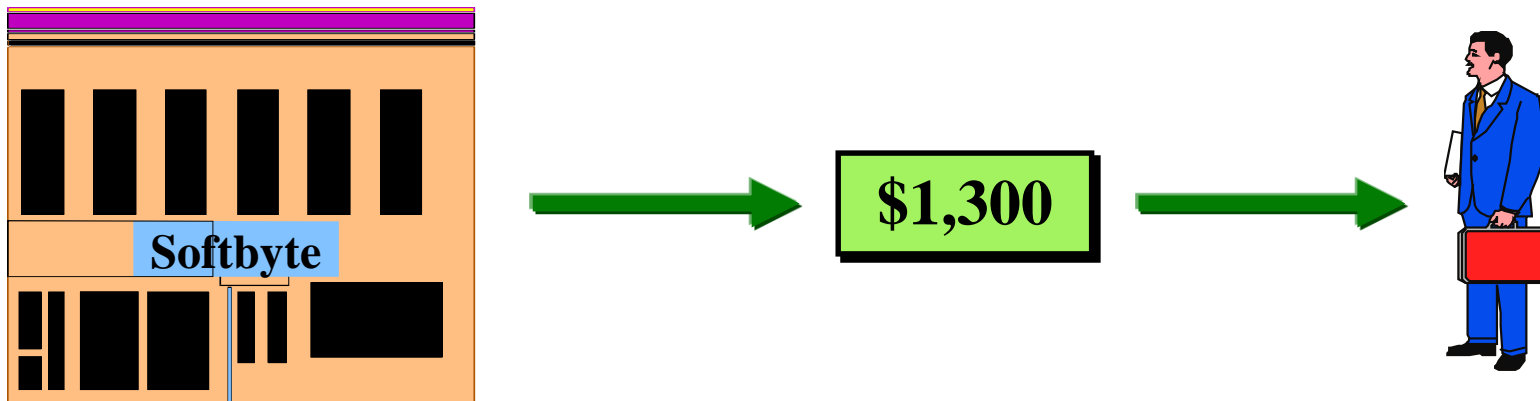
- New
- $$\$9,350 + \$1,400 + \$1,600 + \$7,000 = \$1,600 + \$17,750$$
- $$\$19,350 = \$19,350$$

Cash is increased by \$600 and Accounts Receivable is decreased by the same amount. R. Neal, Capital is not increased because the revenue was already recorded.

TRANSACTION ANALYSIS

TRANSACTION 10

- **Ray Neal** withdraws \$1,300 in cash from the business for his personal use.



TRANSACTION ANALYSIS

TRANSACTION 10 SOLUTION

- $$\underline{\text{Assets}} = \underline{\text{Liabilities}} + \underline{\text{Owner's Equity}}$$
- $$\underline{\text{Cash}} + \underline{\text{Accts. Rec.}} + \underline{\text{Supplies}} + \underline{\text{Equip}} = \underline{\text{Accts. Pay.}} + \underline{\text{R. Neal, Capital}}$$
- Old
- $$\$9,350 + \$1,400 + \$1,600 + \$7,000 = \$1,600 + \$17,750$$
- (10)
- $$\underline{- 1,300} \qquad \qquad \qquad \underline{\text{Drawing}} \qquad \qquad \qquad - \qquad \qquad \qquad \underline{1,300}$$
- New
- $$\underbrace{\$8,050 + \$1,400 + \$1,600 + \$7,000}_{\$18,050} = \underbrace{\$1,600 + \$16,450}_{\$18,050}$$
-

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.

FINANCIAL STATEMENTS

STUDY OBJECTIVE 8

• **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

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.		
Income Statement		
For the Month Ended September 30, 2005		
Revenues		
Service revenue		\$ 4,700
Expenses		
Salaries expense	\$ 900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		\$ 2,750

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.

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC.		
Owner's Equity Statement		
For the Month Ended September 30, 2005		
Retained earnings, September 1, 2005		\$ -0-
Add: Investments	\$ 15,000	
Net income	<u>2,750</u>	<u>17,750</u>
		17,750
Less: Drawings		<u>1,300</u>
Retained earnings, September 30, 2005		<u><u>•\$16,450</u></u>

Net income of \$2,750 carried forward from the income statement to the owner's equity statement. The owner's capital of \$16,450 at the end of the reporting period is shown as the final total of the owner's equity column of the Summary of Transactions (Illustration 1-8).

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC. Balance Sheet September 30, 2005		
Assets		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		7,000
Total assets		<u><u>\$ 18,050</u></u>
Liabilities and Owner's Equity		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
R. Neal, capital		<u>•16,450</u>
Total liabilities and owner's equity		<u><u>\$ 18,050</u></u>

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.

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

SOFTBYTE, INC. Balance Sheet September 30, 2005		
Assets		
Cash		•\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		7,000
Total assets		<u><u>\$ 18,050</u></u>
Liabilities and Owner's Equity		
Liabilities		
Accounts payable		\$ 1,600
Owner's equity		
R. Neal, capital		16,450
Total liabilities and owner's equity		<u><u>\$ 18,050</u></u>

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

FINANCIAL STATEMENTS AND THEIR INTERRELATIONSHIPS

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		<u>1,350</u>
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	<u>(1,300)</u>	
Net cash provided by financing activities		<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>-0-</u>
Cash at the end of the period		<u><u>•\$ 8,050</u></u>

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 1-8).