Learning Objectives

1. Define accounting, and describe the users of accounting information
2. Explain why ethics and rules of conduct are crucial in accounting and business
3. Describe and discuss the forms of business organizations
4. Explain the development of accounting standards, and describe the concepts and principles
5. Describe and use the accounting equation to analyze business transactions
6. Prepare and evaluate the financial statements

Doug Copely is a college student. After successfully completing his first term in December, Doug started looking for a summer job that would pay him enough to cover his expenses for his second year of school. He noticed an advertisement from College Joe Painters. Doug met with the managers of College Joe Painters and was granted a franchise to operate in Richmond, a suburb of Vancouver. Doug’s income would be determined by his ability to successfully operate his own business. Overnight, Doug became an entrepreneur. He had to find customers, hire painters, set up an office, and learn some basic bookkeeping. By the time the second term of school had ended in April, Doug had lined up enough work to keep two crews of painters working full-time for the entire summer.

“I’ve never worked so hard in my life,” Doug confided. “It’s been a lot of fun but a lot of work. I had to learn how to bid for jobs, deal with customers, and find painters. My objective is to make enough income to pay for my tuition, books, and room and board next year. I think I’ve succeeded, but I won’t know for sure until I prepare financial statements at the end of the summer. I never knew keeping track of my expenses would be so important!”
Part 1

The Basic Structure of Accounting

What role does accounting play in Doug Copely’s situation? Doug had to decide how to organize his franchise. He set up his business as a proprietorship—a single-owner company—with Doug Copely as the owner. As the business grows, he may consider joining forces with a fellow franchisee to form a partnership or he could choose to incorporate—that is, to form a corporation. In this chapter, we discuss all three forms of business organization: proprietorships, partnerships, and corporations.

You may already know various accounting terms and relationships, because accounting affects people’s behaviour in many ways. This first accounting course will sharpen your focus by explaining how accounting works. As you progress through this course, you will see how accounting helps people like Doug Copely—and you—achieve business goals.

Accounting: The Language of Business

Accounting is the information system that measures business financial activities, processes that information into reports, and communicates the results to decision makers. For this reason it is called “the language of business.” The better you understand the language, the better your decisions will be, and the better you can manage financial information. A recent survey indicates that business managers believe it is more important for college students to learn accounting than any other business subject. Decisions concerning personal financial planning, education expenses, loans, car payments, income taxes, and investments are based on the information system that we call accounting.

Financial statements are a key product of an accounting system and provide information that helps people make informed business decisions. Financial statements report on a business in monetary terms. Is my business making a profit? Should I hire assistants? Am I earning enough money to expand my business? Answering business questions like these requires the financial statements.

Students sometimes mistake bookkeeping for accounting. Bookkeeping is a procedural element of accounting, just as arithmetic is a procedural element of mathematics. Increasingly, people are using computers to do detailed bookkeeping—in households, businesses, and organizations of all types. Exhibit 1–1 illustrates the role of accounting in business. The process starts and ends with people making decisions.
Decision Makers: The Users of Accounting Information

Decision makers need information. The more important the decision, the greater the need for information. Virtually all businesses and most individuals keep accounting records to aid decision making. Here are some decision makers who use accounting information.

Individuals People use accounting information in day-to-day affairs to manage bank accounts, evaluate job prospects, make investments, and decide whether to lease or buy a new car.

Businesses Business owners and managers use accounting information to set goals for their organizations. They evaluate their progress toward those goals, and they take corrective action when it is necessary. For example, Doug Copely of College Joe Painters makes decisions, based on accounting information, that include which jobs to accept, how many painters to hire, and how much to charge customers to meet his goal of earning enough to pay for school.

Investors Outside investors often provide the money a business needs to begin operations. To decide whether to invest, potential investors predict the amount of income to be earned on their investment. This evaluation means analyzing the financial statements of the business and keeping up with developments in the business press, for example, The Financial Post (a part of The National Post) and Report on Business published by The Globe and Mail.

Creditors Before loaning money, creditors (lenders) such as banks evaluate the borrower’s ability to make scheduled payments. This evaluation includes a report of the borrower’s financial position and a prediction of future operations, both of which are based on accounting information.

Government Regulatory Agencies Most organizations face government regulation. For example, the provincial securities commissions, such as the Ontario Securities Commission, dictate that businesses that sell their shares to or borrow money from the public disclose certain financial information to the investing public.

Taxing Authorities Provincial and federal governments levy taxes on individuals and businesses. Income tax is calculated using accounting information. Businesses use their accounting records to help them determine their goods and services tax and sales tax.
**Nonprofit Organizations** Nonprofit organizations such as churches, hospitals, government agencies, and colleges, which operate for purposes other than to earn a profit, use accounting information in much the same way that profit-oriented businesses do.

**Other Users** Employees and labour unions may make wage demands based on the accounting information that shows their employer’s reported income. Consumer groups and the general public are also interested in the amount of income that businesses earn. And newspapers may report “an improved profit picture” of a major company as it emerges from economic difficulties. Such news, based on accounting information, is related to the company’s health.

**Financial Accounting and Management Accounting**

Users of accounting information are a diverse population, but they may be grouped as external users or internal users. This distinction allows us to classify accounting into two fields—financial accounting and management accounting.

Financial accounting provides information to people outside the company. Creditors and outside investors, for example, are not part of the day-to-day management of the company. Likewise, government agencies and the general public are external users of a company’s accounting information. Chapters 2 through 18 in Volumes I and II of this book deal primarily with financial accounting.

Management accounting generates information for internal decision makers, such as company executives, department heads, college deans, and hospital administrators. Chapters 19 through 26 in Volume III of this book cover management accounting.

Exhibit 1–2 shows how financial accounting and management accounting are used by Doug Copely’s College Joe Painter’s internal and external decision makers.

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**The History and Development of Accounting**

Accounting has a long history. Some scholars claim that writing arose in order to record accounting information. Account records date back to the ancient civilizations of China, Babylonia, Greece, and Egypt. The rulers of these civilizations used accounting to keep track of the cost of labour and materials used in building structures like the great pyramids. The need for accounting has existed as long as there has been business activity.

Accounting developed further as a result of the information needs of merchants in the city-states of Italy during the 1400s. In that busy commercial climate, the monk Luca Pacioli, a mathematician and friend of Leonardo da Vinci, published the first known description of double-entry bookkeeping in 1494.
In the Industrial Revolution of the nineteenth century, the growth of corporations spurred the development of accounting. The corporation owners—the shareholders—were no longer necessarily the managers of their business. Managers had to create accounting systems to report to the owners and government how well their businesses were doing. Because managers want their performance to look good, society needs a way to ensure that the business information provided is reliable. To meet this need, generally accepted accounting principles were developed. These will be discussed in more detail shortly.

Like other segments of society, accounting must be practiced in an ethical manner. We look next at the ethical dimension of accounting.

Ethical Considerations in Accounting and Business

Ethical considerations affect all areas of accounting and business. Investors, creditors, and regulatory bodies need relevant and reliable information about a company. Naturally, companies want to make themselves look as good as possible to attract investors, so there is a potential for conflict. An audit is a financial examination. Audits are conducted by independent accountants who express an opinion on whether or not the financial statements fairly reflect the economic events that occurred during the accounting period. It is vital that companies and their auditors behave in an ethical manner. Exhibit 1–3 illustrates the relationship among accounting and business entities.

Unfortunately for the accounting profession, accounting scandals involving both public companies and their auditors have made the headlines in recent years. Most of these incidents occurred in the United States. For example, Enron Corporation, which was the seventh-largest company in the United States, allegedly issued misleading financial statements that reported fewer debts than the company really owed. Enron was forced into bankruptcy and its auditors were forced out of business (although on May 31, 2005, the U.S. Supreme Court overturned the Arthur Andersen accounting firm’s conviction). The impact of the Enron bankruptcy was felt by many different parties, including Enron shareholders, who saw their investments become worthless, employees who lost their jobs and their pension funds, and the accounting profession, which lost some of its integrity and reputation as gatekeepers and stewards for the investing public. Scandals like this shocked the business community and hurt investor confidence.

In response to the scandals, the Sarbanes-Oxley Act of 2002 was introduced. It is landmark legislation designed to make U.S. public companies more transparent.
in their financial reporting and more proactive in sharing material information with other participants in the financial reporting chain, including auditors, audit committees, analysts, and investors. If Canadian companies are registered in the United States, they must follow the rules of the Sarbanes-Oxley Act. Nortel Networks Corporation, the Canadian communication-networks company, was forced to comply with these rules and, as a result, restated its December 31, 2004, financial statements.

Rather than move toward U.S. standards, there is a movement in Canada toward the convergence of Canadian standards with International Financial Reporting Standards (IFRSs) over a transition period, expected to be five years.

In this book, we provide several problems that allow you to consider ethical dilemmas. Consider them carefully. The perception that accountants follow the highest standard of professional conduct must also be the reality. In today’s business climate, behaving in an ethical manner is crucial.

The Professional Accounting Bodies and Their Standards of Professional Conduct

Chartered Accountants (CAs), Certified General Accountants (CGAs), and Certified Management Accountants (CMAs) are all governed by rules of conduct created by their respective organizations. Many of the rules apply whether the members are public accountants working in public practice or private accountants working in industry or government. These rules concern the confidentiality of information the accountant is privy to, maintenance of the reputation of the profession, the need to perform their work with integrity and due care, competence, refusal to be associated with false or misleading information, and compliance by the accountant with professional standards. Other rules are applicable only to those members in public practice, and deal with things like the need for independence, and how to advertise, seek clients, and conduct a practice.

The rules of conduct serve both the members of the accounting bodies and the public. The rules serve members by setting standards that they must meet, and providing a benchmark against which they will be measured by their peers. The public is served because the rules of conduct provide it with a list of the standards to which the members of the body adhere. This helps the public determine its expectations of members’ behaviour. However, the rules of conduct should be considered a minimum standard of performance; ideally, the members should continually strive to exceed them.

Codes of Business Conduct of Companies

Many companies have codes of conduct that apply to their employees in their dealings with each other and with the companies’ suppliers and customers. Some of these companies mention their code in the annual report or on their website. For example, Vancouver City Savings Credit Union states on its website:

Our Values
Integrity: We act with courage, consistency and respect to do what is honest, fair and trustworthy.
Innovation: We anticipate and respond to challenges and changing needs with creativity, enthusiasm and determination.
Responsibility: We are accountable to our members, employees, colleagues and communities for the results of our decisions and actions.1

The company indicates to its employees and to the general public how management expects employees to behave.

1From Vancouver City Savings Credit Union’s website, www.vancity.com (accessed March 16, 2006).
Types of Business Organizations

A business can be organized as a

- Proprietorship
- Partnership
- Corporation

You should understand the differences among the three.

**Proprietorship** A proprietorship has a single owner, called the proprietor, who often manages the business. Proprietorships tend to be small retail stores and individual professional businesses, such as those of physicians, lawyers, and accountants, but also can be very large. From the accounting viewpoint, each proprietorship is distinct from its owner. Thus the accounting records of the proprietorship do not include the proprietor’s personal accounting records. However, from a legal perspective, the business is the proprietor. In this book, we start with a proprietorship because many students organize their first business that way.

**Partnership** A partnership joins two or more individuals together as co-owners. Each owner is a partner. Many retail stores and professional organizations of physicians, lawyers, and accountants are partnerships. Most partnerships are small and medium-sized, but some are quite large; there are public accounting firms in Canada with more than 500 partners and law firms with more than 100 partners. Accounting treats the partnership as a separate organization distinct from the personal affairs of each partner. But again, from a legal perspective, a partnership is the partners in a manner similar to the proprietorship.

**Corporation** A corporation is a business owned by shareholders. These are the people or other corporations who own shares of ownership in the business. The corporation is the dominant form of business organization in Canada. Although proprietorships and partnerships are more numerous, corporations engage in more business and are generally larger in terms of total assets, income, and number of employees. In Canada, generally, corporations must have Ltd. or Limited, Inc. or Incorporated, or Corp. or Corporation in their legal name to indicate that they are incorporated. Corporations need not be large; a business with only a few assets and employees could be organized as a corporation.

From a legal perspective, a corporation is formed when the federal government or a provincial government approves its articles of incorporation. Unlike a proprietorship or partnership, a corporation is a legal entity distinct from its owners. The corporation operates as an “artificial person” that exists apart from its owners and that conducts business in its own name. The corporation has many of the rights that a person has. For example, a corporation may buy, own, and sell property. The corporation may enter into contracts and sue and be sued.

Corporations differ significantly from proprietorships and partnerships in another way. If a proprietorship or partnership cannot pay its debts, lenders can take the owners’ personal assets—cash and belongings—to satisfy the business’s obligations. But if a corporation goes bankrupt, lenders cannot take the personal assets of the shareholders. This limited personal liability of shareholders for corporate debts explains why corporations are so popular compared to proprietorships and partnerships. Exhibit 1–4 shows the formation and ownership of a corporation.

Another factor for corporations is the division of ownership into individual shares. Companies such as BCE Inc., Canadian Imperial Bank of Commerce, and Canadian Tire Corporation, Limited have issued millions of shares of stock and have tens of thousands of shareholders. An investor with no personal relationship either to the corporation or to any other shareholder can become an owner by buying 30, 100, 5,000, or any number of shares of its stock. For most corporations, the investor may sell the shares at any time. It is usually harder to sell one’s investment in a proprietorship or a partnership than to sell one’s investment in a corporation.
Limited-Liability Partnership (LLP) and Limited-Liability Company (LLC) A limited-liability partnership (LLP) is a partnership in which one partner cannot create a large liability for the other partners. Each partner is liable only for his or her own actions and those actions under his or her control. A proprietorship can be organized as a limited-liability company (LLC), where the company and not the proprietor is liable for the company’s debts. Today, most proprietorships and partnerships are organized as LLCs and LLPs. The limited-liability aspect gives these organizations one of the chief advantages of a corporation.

Exhibit 1–5 summarizes the differences between proprietorships, partnerships, and corporations.

| 1. Owner(s) | Proprietor—one owner | Partners—two or more owners | Shareholders—generally many owners |
| 2. Life of organization | Limited by owner’s choice or death | Limited by owners’ choices or death | Indefinite |
| 3. Personal liability of owner(s) for business debts | Proprietor is personally liable* | Partners are personally liable** | Shareholders are not personally liable |
| 4. Legal status | The proprietorship is the proprietor* | The partnership is the partners** | The corporation is separate from the shareholders (owners) |

*Unless it is a limited-liability company (LLC)
**Unless it is a limited-liability partnership (LLP)

Accounting for corporations includes some unique complexities. For this reason, we initially focus on proprietorships. We cover partnerships in Chapter 12 and begin our discussion of corporations in Chapter 13.

**Objective 4**
Explain the development of accounting standards, and describe the concepts and principles

Accounting Concepts

Accounting practices follow certain guidelines. The rules that govern how accountants measure, process, and communicate financial information fall under the heading GAAP, which stands for generally accepted accounting principles. In Canada, the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA) is responsible for creating GAAP. The AcSB consists of a maximum of nine members from a variety of backgrounds. Members are chosen so that the AcSB has an appropriate balance of competencies and expertise to set accounting standards. The federal and provincial legislatures through the various companies’ acts and the various provincial securities commissions have given the standards or GAAP issued by the AcSB and collected in the CICA Handbook their legal status.

Accounting principles draw their authority from their acceptance in the business community. They are generally accepted by those people and organizations who need guidelines in accounting for their financial undertakings.

Currently, GAAP in Canada are based on the CICA Handbook, Section 1000, Financial Statement Concepts, and Section 1100, Generally Accepted Accounting Principles. Section 1100 lists the sources of GAAP in Canada, which include accounting sections in the CICA Handbook and other guidelines, abstracts, and background information issued by the Accounting Standards Board of the CICA and its committees. Section 1100 states that standards can change over time to reflect changes in economic and social conditions. Section 1100 also states that the Handbook cannot (and is not intended to) address every possible financial transaction or situation. When a transaction or situation is not addressed specifically in the Handbook or other primary sources of GAAP listed in Section 1100, then accountants should refer to Section 1000 and apply their professional judgment.
Exhibit 1–6 summarizes the financial statement concepts described in Handbook Section 1000. Level 1 in Exhibit 1–6 shows that the primary objective of financial statements is to provide information useful for making resource allocation decisions (helping people decide where to invest their money) and for assessing management’s stewardship (judging whether managers are running a company well).

The qualitative characteristics that increase the value of accounting information appear in Level 2 of Exhibit 1–6.

To be useful, information must be understandable, relevant, and reliable, as well as comparable. The information must be understandable to users if they are to be able to use it. Relevant information influences decisions and is useful for making predictions and for evaluating past performance. Reliable information is free from error and the bias of a particular viewpoint; it is in agreement with the underlying events and transactions. Comparable information is information that is produced by organizations using the same accounting principles and policies, and that allows comparison between the organizations. Comparability also allows comparisons over time or at two points in time.

There are two constraints to providing information to users that is understandable, relevant, reliable, and comparable. They are shown in Level 4 of Exhibit 1–6. The first constraint is that the benefits of the information produced should exceed the costs of producing the information, as stated in Paragraph 1000.16 in the CICA Handbook. The second constraint is materiality, as stated in Paragraph 1000.17; a piece of information is material if it would affect a decision maker’s decision. Materiality is not defined in the standards but is a matter of the information preparer’s judgment. For example, information about inventory is important to users of Canadian Tire’s financial statements, since a change in inventory could change a decision maker’s decision about investing in Canadian Tire or selling products to Canadian Tire. Thus, such information would be provided to decision makers. However, information about the supplies inventory at Coast Capital Savings Credit Union would not likely change the investment decision of a member of the credit union, so details of such information are not provided.
Level 3 in Exhibit 1–6 shows the standard elements of the financial statements. We will learn more about these items later in this chapter. In addition to the constraints described above, Level 4 in Exhibit 1–6 also contains the recognition and measurement criteria that form the basis of GAAP.

Exhibit 1–6 summarizes the key points of Handbook Section 1000: For any financial transaction or situation, the GAAP in Level 4 are used as guidelines for classifying the transaction’s financial data into the standard financial-statement elements shown in Level 3. If these elements meet the Level-2 qualitative characteristics of accounting information, they are combined into financial statements that meet the Level-1 objective of reporting financial information useful for users.

This course will expose you to the generally accepted methods of accounting. We begin the discussion of GAAP in this section and introduce additional assumptions and principles as needed throughout the book.

Appendix C at the end of Volume I and II summarizes the major elements of generally accepted accounting principles.

The Economic-Entity Assumption

The most basic assumption in accounting is that of the entity. An accounting entity is an organization or a section of an organization that stands apart from other organizations and individuals as a separate economic unit. From an accounting perspective, sharp boundaries are drawn around each entity so as not to confuse its affairs with those of other entities.

Suppose you decided to tutor other students, so you started a proprietorship. After the first year, you had $2,000 in your bank account. Suppose only $1,000 of that amount came from your business’s operation. The other $1,000 was a gift from your parents. If you follow the entity concept, you will keep separate the money generated by the business—one economic unit—from the money generated by the gift from your family—a second economic unit. This separation makes it possible to view the business’s operating result clearly; otherwise, you might be misled into believing that the business produced more cash than it did.

The economic-entity assumption also applies to nonprofit organizations such as churches, synagogues, and government agencies. A hospital, for example, may have an emergency room, a pediatrics unit, and a surgery unit. The accounting system of the hospital should account for each separately to allow the managers to evaluate the progress of each unit.

In summary, the transactions of different entities making up the whole organization should not be accounted for together. Each entity should be accounted for separately, and then later, the results of each entity can be combined to create results for the whole organization.

The Reliability Characteristic

Accounting records and statements are based on the most reliable data available so that they will be as accurate and useful as possible. This guideline is the reliability characteristic, also called the objectivity characteristic. Reliable data are verifiable. They may be confirmed by any independent observer. For example, a purchase of supplies can be supported by paid invoices. A paid invoice is objective evidence of the cost of the supplies. Ideally, accounting records are based on information that flows from activities that are documented using objective evidence. Without the reliability characteristic, accounting records might be based on whims and opinions and would be subject to dispute.

Suppose you want to open a music store. To have a place for operations, you transfer a small building to the business. You believe the building is worth $200,000. Two real-estate professionals appraise the building at $190,000. Is $200,000 or $190,000 the more reliable estimate of the building’s value? The real-estate appraisal
of $190,000 is, because it is supported by independent, objective observations. The business should record the building at a cost of $190,000.

**The 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 actually paid and not at the “expected” cost. Suppose your music store purchased some compact discs from a supplier who was going out of business. Assume you got a good deal on this purchase and paid only $5,000 for merchandise that would have cost you $8,000 elsewhere. The cost principle requires you to record this merchandise at its actual cost of $5,000, not the $8,000 that you believe the compact discs to be worth.

The cost principle also holds that the accounting records should continue reporting 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 compact discs for three months. During that time, compact disc prices increase, and the compact discs can be sold for $9,000. Should their accounting value—the figure “on the books”—be the actual cost of $5,000 or the current market value of $9,000? According to the cost principle, the accounting value of the compact discs remains at actual cost of $5,000. There are some exceptions—investments are discussed in Chapter 16.

**The Going-Concern Assumption**

Another reason for measuring assets at historical cost is the *going-concern assumption*, which assumes that the entity will remain in operation for the foreseeable future. Most assets—that is, the firm’s resources, such as supplies, land, buildings, automobiles, and equipment—are acquired to use rather than to sell. Under the going-concern assumption, accountants assume the business will remain in operation long enough to use existing assets for their intended purpose.

To understand the going-concern assumption, assume a business bought a delivery van for $5,000 and it is now worth $3,000. The going-concern assumption ensures that proper accounting procedures are followed, as if the business is going to continue operating indefinitely. For a going concern, the delivery van is valued at its cost of $5,000 in the accounting records. However, if the business is holding a Going-Out-of-Business Sale, it would want to value the delivery van at $3,000 in the accounting records because that is the amount the business could sell it for today, on its final day of business. Accountants assume a business will operate indefinitely.

**The Stable-Monetary-Unit Assumption**

We think of the cost of a loaf of bread and a month’s apartment rent in terms of their dollar value. In Canada, accountants record transactions in dollars because the dollar is the medium of exchange. French and German transactions are measured in euros. The Japanese record transactions in yen.

Unlike a litre, a kilometre, or a tonne, the value of a dollar or a euro changes over time. A rise in the general level of prices is called *inflation*. During inflation a dollar will purchase less milk, less toothpaste, and less of other goods. When prices are relatively stable—when there is little inflation—the purchasing power of money is also stable.

Accountants assume that the dollar’s purchasing power is relatively stable. The *stable-monetary-unit assumption* 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. In certain countries in South America, where inflation rates are often high, accountants make adjustments to report monetary amounts in units of current buying power—a very different concept.
The Accounting Equation

Financial statements tell us how a business is performing and where it stands. They are the final product of the accounting process. But how do we arrive at the items and amounts that make up the financial statements? The most basic tool of the accountant is the accounting equation. It measures the resources of a business and the claims to those resources.

Assets and Liabilities

Assets are economic resources that are expected to benefit the business in the future. Cash, office supplies, merchandise inventory, furniture, land, and buildings are examples of assets.

Claims to those assets come from two sources. Liabilities are debts that are payable to outsiders. These outside parties are called creditors. For example, a creditor who has loaned money to a business has a claim—a legal right—to a part of the assets until the business pays the debt. Many liabilities have the word payable in their titles. Examples include Accounts Payable, Notes Payable, and Salaries Payable. Insider claims to the business assets are owners’ claims called owner’s equity or capital. An owner’s claim to some of the entity’s assets begins when the owner invests in the business.

The accounting equation in Exhibit 1–7 shows how assets, liabilities, and owner’s equity are related. Assets appear on the left side of the equation. The legal and

EXHIBIT 1-7
The Accounting Equation

Assets = Liabilities + Owner’s Equity

STOP AND THINK

Suppose you are considering the purchase of land for future expansion. The seller is asking $100,000 for land that cost her $70,000. An appraisal shows the land has a value of $94,000. You first offer $80,000. The seller counteroffers with $96,000. Finally, you and the seller agree on a price of $92,000. What dollar amount for this land is reported on your financial statements? Which accounting assumption or principle guides your answer?

Answer: According to the cost principle, goods and services should be recorded at their actual cost. You paid $92,000 for the land. Therefore, $92,000 is the cost to report on your financial statements.

STOP AND THINK

1. If the assets of a business are $10,000 and the liabilities total $2,000, how much is the owner’s equity?

2. If the owner’s equity in a business is $20,000 and the liabilities are $5,000, how much are the assets?

Answers: To answer both questions, use the accounting equation:

1. \[ \text{Assets} - \text{Liabilities} = \text{Owner’s Equity} \]
   \[ $10,000 - $2,000 = $8,000 \]

2. \[ \text{Assets} = \text{Liabilities} + \text{Owner’s Equity} \]
   \[ $25,000 = $5,000 + $20,000 \]
Decreases in cash are not always expenses. Cash decreases when land is purchased, for example, but the purchase also increases the asset Land, which is not an expense. Expenses result from using goods or services in the course of earning revenue, not necessarily from the payment of cash.

Increases in cash are not always revenues. Cash also increases when a company borrows money, but borrowing money creates a liability— not a revenue. Revenue results from rendering a service or selling a product, not necessarily from the receipt of cash.

A transaction is an event that must always satisfy these two conditions:
1. It affects the financial position of the business entity and can be measured reliably.
2. It can be reliably recorded in the accounting records.

As Exhibit 1–7 shows, the two sides must be equal:

\[
\text{Economic Resources (Outsiders)} = \text{Claims to Economic Resources (Insiders)}
\]

\[
\text{ASSETS} = \text{LIABILITIES} + \text{OWNER’S EQUITY}
\]

**Owner’s Equity**

Owner’s equity is the amount of an entity’s assets that remains after the liabilities are subtracted. For this reason, owner’s equity is often referred to as net assets and the accounting equation can be written to show this:

\[
\text{ASSETS} - \text{LIABILITIES} = \text{OWNER’S EQUITY}
\]

The purpose of business is to increase owner’s equity through revenues, which are amounts earned by delivering goods or services to customers. Revenues increase owner’s equity because they increase the business’s assets but not its liabilities. As a result, the owner’s share of business assets increases. Examples of revenue include sales revenue from selling goods, service revenue from selling services, interest revenue from saving money in a bank, and dividend revenue from investing in shares of stock. Exhibit 1–8 shows that owner investments and revenues increase the owner’s equity of the business.

Exhibit 1–8 also shows that owner withdrawals and expenses decrease owner’s equity. Owner withdrawals are those amounts or resources removed from the business by the owner. Withdrawals are the opposite of owner investments. Expenses are decreases in owner’s equity that occur from using or consuming assets or increasing liabilities in the course of delivering goods and services to customers. Expenses are the cost of doing business and are the opposite of revenues. Expenses include the cost of office rent, interest payments, salaries of employees, insurance, advertisements, property taxes, utility payments for water, electricity, gas, and so forth.

**Exhibit 1–8** Transactions That Increase and Decrease Owner’s Equity

**EXHIBIT 1–8**

<table>
<thead>
<tr>
<th>INCREASE</th>
<th>DECREASE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Owner Investments in the Business</td>
<td>Owner Withdrawals from the Business</td>
</tr>
<tr>
<td>Revenues</td>
<td>Expenses</td>
</tr>
</tbody>
</table>

**Accounting for Business Transactions**

Accounting is based on transactions, not opinions or desires. A transaction is any event that affects the financial position of the business entity and can be measured reliably. Many events may affect a company, including elections and economic booms. Accountants do not record the effects of these events because they cannot be measured reliably. An accountant records as transactions only events with dollar amounts that can be measured reliably, such as purchases and sales of merchandise inventory, payment of rent, and collection of cash from customers. In Exhibit 1–1 on page 3, transactions are the middle step in the flow of information in an accounting system.

To illustrate accounting for business transactions, let’s assume that John Lapp opens a travel agency that he calls SuperTravel. We will now consider 11 events...
and analyze each in terms of its effect on the accounting equation of SuperTravel. *Remember that the accounting equation must always remain in balance.* Transaction analysis is the essence of accounting.

**Transaction 1: Starting the Business** John Lapp invests $60,000 of his money to start the business. Specifically, he deposits $60,000 in a bank account entitled SuperTravel.

The effect of this transaction on the accounting equation of the SuperTravel business entity is

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>John Lapp, Capital</td>
</tr>
<tr>
<td>60,000</td>
<td></td>
<td>+60,000</td>
</tr>
</tbody>
</table>

For every transaction, the amount on the left side of the equation must equal the amount on the right side. The first transaction increases both the assets (in this case, Cash) and the owner’s equity of the business (John Lapp, Capital). The transaction involves no liabilities of the business because it creates no obligation for SuperTravel to pay an outside party. The Assets and Liabilities elements of the accounting equation will be expanded to show the specific accounts affected by a transaction, but Owner’s Equity will not be expanded. Therefore, to the right of the transaction, we write “owner investment” to keep track of the reason for the effect on Owner’s Equity.

**Transaction 2: Purchase of Land** SuperTravel purchases land for a future office location, paying cash of $40,000. The effect of this transaction on the accounting equation is

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>John Lapp, Capital</td>
</tr>
<tr>
<td>Bal. 60,000</td>
<td></td>
<td>+60,000</td>
</tr>
<tr>
<td>(2) -40,000</td>
<td>+40,000</td>
<td></td>
</tr>
<tr>
<td>Bal. 20,000</td>
<td>-40,000</td>
<td>60,000</td>
</tr>
<tr>
<td></td>
<td>60,000</td>
<td>60,000</td>
</tr>
</tbody>
</table>

The cash purchase of land increases one asset, Land, and decreases another asset, Cash, by the same amount. After the transaction is completed, SuperTravel has cash of $20,000, land of $40,000, no liabilities, and owner’s equity of $60,000.

**STOP AND THINK**

The realtor that arranged SuperTravel’s land purchase assures the company that the land is worth $75,000. Could the company ethically record the land at $75,000?

**Answer:** Regardless of the realtor’s belief about the true value of the land, it is recorded at $40,000 because of the cost principle and the reliability characteristic. Actual cost is a reliable measure of an asset.

**Transaction 3: Purchase of Office Supplies** SuperTravel buys stationery and other office supplies, agreeing to pay $1,000 within 30 days. This transaction increases both the assets and the liabilities of the company, as follows:
The asset affected is Office Supplies, and the liability is called an account payable. A payable is always a liability. Because SuperTravel is obligated to pay $1,000 in the future but signs no formal promissory note, we record the liability as an Account Payable. (If a promissory note had been signed, we would have recorded the liability as a Note Payable.)

Transaction 4: Earning of Service Revenue SuperTravel earns service revenue by providing travel arrangement services for clients. Assume the business earns $5,000 and collects this amount in cash. The effect on the accounting equation is an increase in the asset Cash and an increase in John Lapp, Capital, as follows:

A revenue transaction causes the business to grow, as shown by the increase in total assets and in the sum of total liabilities plus owner’s equity. A company like Canadian Tire or Zellers that sells goods to customers is a merchandising business. Its revenue is called sales revenue. In contrast, SuperTravel performs services for clients. SuperTravel’s revenue is called service revenue.

STOP AND THINK

SuperTravel has now completed four business transactions. Answer these questions about the business:

1. How much in total assets does SuperTravel have to work with?
2. How much of the total assets does SuperTravel actually own? How much does SuperTravel owe to outsiders?

Answers:

1. SuperTravel owns three assets totalling $66,000, which is the sum of cash ($25,000) + office supplies ($1,000) + land ($40,000).
2. SuperTravel or John Lapp owns $65,000, the amount of owner’s equity. The business owes $1,000 (Accounts Payable) to outsiders.
Transaction 5: Earning of Service Revenue on Account  
SuperTravel performs services for clients who do not pay immediately. In return for the services, SuperTravel issues an invoice and the clients will pay the $6,000 amount within one month. This debt is an asset to SuperTravel, an account receivable because the business expects to collect the cash in the future. In accounting, we say that SuperTravel performed this service on account and earned the revenue. Performing the service, not collecting the cash, earns the revenue. This $6,000 of service revenue is as real an increase in the wealth of SuperTravel’s business as the $5,000 of revenue that was collected immediately in Transaction 4. SuperTravel records an increase in the asset Accounts Receivable and an increase in Service Revenue, which increases John Lapp, Capital, as follows:

![Accounting Equation](image)

Transaction 6: Payment of Expenses  
During the month, SuperTravel pays $5,200 in cash expenses: office rent, $2,200; employee salary, $2,400 (for a part-time assistant); and total utilities, $600. The effects on the accounting equation are

![Accounting Equation](image)

Expenses have the opposite effect of revenues. Expenses cause the business to shrink, as shown by the decreased balances of total assets and owner’s equity.

Each expense should be recorded in a separate transaction. Here, for simplicity, the expenses are listed together. Alternatively, we could record the cash payment in a single amount for the sum of those three expenses, $5,200 ($2,200 + $2,400 + $600). In either case, the “balance” of the equation holds, as we know it must.

Transaction 7: Payment on Account  
SuperTravel pays $800 to the store from which it purchased $1,000 worth of office supplies in Transaction 3. In accounting, we say that the business pays $800 on account. The effect on the accounting equation is a decrease in the asset Cash and a decrease in the liability Accounts Payable as follows:
The payment of cash on account has no effect on the asset Office Supplies because the payment does not increase or decrease the supplies available to the business. Likewise, the payment on account does not affect expenses. SuperTravel was paying off a liability, not an expense.

**Transaction 8: Personal Transaction** John Lapp remolds his home at a cost of $30,000, paying cash from personal funds. This event is not a transaction of SuperTravel. It has no effect on SuperTravel’s business affairs and therefore is not recorded by the business. It is a transaction of the John Lapp personal entity, not the SuperTravel business entity. We are focusing now solely on the business entity, and this event does not affect it. This transaction illustrates the economic-entity assumption.

**Transaction 9: Collection on Account** In Transaction 5, SuperTravel performed services for clients on account. The business now collects $2,000 from a client. We say that it collects the cash on account. It will record an increase in the asset Cash and a decrease in the asset Accounts Receivable. Should it also record an increase in service revenue? No, because SuperTravel already recorded the revenue when it performed the service in Transaction 5. The effect on the accounting equation is

Total assets are unchanged from the preceding transaction’s total. Why? Because SuperTravel merely exchanged one asset for another.

**Transaction 10: Sale of Land** John Lapp sells a parcel of land owned by SuperTravel. The sale price of $22,000 is equal to SuperTravel’s cost of the land. SuperTravel sells the land and receives $22,000 cash, and the effect on the accounting equation is
**Transaction 11: Withdrawing of Cash** John Lapp withdraws $2,000 cash for his personal use. The effect on the accounting equation is

\[
\begin{array}{c|c|c|c|c|c}
\hline
\text{Assets} & \text{Liabilities} & \text{Owner's Equity} \\
\hline
\text{Cash} & \text{Accounts Payable} & \text{John Lapp, Capital} \\
\text{Receivable} & & \\
\text{Supplies} & & \\
\text{Land} & & \\
\text{Bal.} & 43,000 & 200 & 65,800 \\
\text{−2,000} & & & \text{−2,000} \\
\text{Bal.} & 41,000 & 200 & 63,800 \\
\hline
\end{array}
\]

John Lapp’s withdrawal of $2,000 cash decreases the asset Cash and also the owner’s equity of the business.

*Owner withdrawals do not represent a business expense because the cash is used for the owner’s personal affairs unrelated to the business.* We record this decrease in owner’s equity as Withdrawals or Drawings. The double underlines below each column indicate a final total after the last transaction.

---

**Evaluating Business Transactions**

Exhibit 1–9 summarizes the 11 preceding transactions. Panel A of the exhibit lists the details of the transactions, and Panel B presents the analysis. As you study the exhibit, note that every transaction maintains the equality of the equation

\[
\text{ASSETS} = \text{LIABILITIES} + \text{OWNER’S EQUITY}
\]

---

**EXHIBIT 1–9** Analysis of Transactions of SuperTravel

**PANEL A: DETAILS OF TRANSACTIONS**

1. The business recorded the $60,000 cash investment made by John Lapp.
2. Paid $40,000 cash for land.
3. Bought $1,000 of office supplies on account.
4. Received $5,000 cash from clients for service revenue earned.
5. Performed services for clients on account, $6,000.
6. Paid cash expenses: rent, $2,200; employee salary, $2,400; utilities, $600.
7. Paid $800 on the account payable created in Transaction 3.
8. Remodelled John Lapp’s personal residence. This is not a transaction of the business.
9. Collected $2,000 on the account receivable created in Transaction 5.
10. Sold land for cash equal to its cost of $22,000.
11. The business paid $2,000 cash to John Lapp as a withdrawal.
The Financial Statements

Once the analysis of the transactions is complete, what is the next step in the accounting process? How does a business present the results of the transactions? We now look at the financial statements, which are the formal reports of an entity’s financial information. The primary financial statements are the:

- Income statement
- Statement of owner’s equity
- Balance sheet
- Cash flow statement

**Income Statement** The income statement presents a summary of the revenues and expenses of an entity for a specific period of time, such as a month or a year. The income statement, also called the statement of earnings or statement of operations, is like a video of the entity’s operations—a moving financial picture of business operations during the period. The income statement holds perhaps the most important single piece of information about a business—its net income or net loss. Businesspeople run their businesses with the objective of having more revenues than expenses. An excess of total revenues over total expenses is called net income, net earnings, or net profit. If total expenses exceed total revenues, the result is called a net loss.

---

### Panel B: Analysis of Transactions

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liabilities + Owner’s Equity</th>
<th>Types of Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Cash + Accounts Receivable + Office Supplies + Land</td>
<td>Accounts Payable + John Lapp, Capital</td>
<td></td>
</tr>
<tr>
<td>(1)</td>
<td>+60,000</td>
<td>+60,000</td>
<td>Owner investment</td>
</tr>
<tr>
<td>Bal.</td>
<td>60,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2)</td>
<td>–40,000</td>
<td>+40,000</td>
<td>Service revenue</td>
</tr>
<tr>
<td>Bal.</td>
<td>20,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3)</td>
<td>20,000</td>
<td>+1,000</td>
<td>Service revenue</td>
</tr>
<tr>
<td>Bal.</td>
<td>20,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(4)</td>
<td>+5,000</td>
<td></td>
<td>Rent expense</td>
</tr>
<tr>
<td>Bal.</td>
<td>25,000</td>
<td>+6,000</td>
<td></td>
</tr>
<tr>
<td>(5)</td>
<td>25,000</td>
<td>+6,000</td>
<td>Salary expense</td>
</tr>
<tr>
<td>Bal.</td>
<td>19,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(6)</td>
<td>–2,200</td>
<td>–2,400</td>
<td>Utilities expense</td>
</tr>
<tr>
<td>Bal.</td>
<td>19,000</td>
<td>–600</td>
<td></td>
</tr>
<tr>
<td>(7)</td>
<td>–800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal.</td>
<td>19,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(8)</td>
<td>Not a transaction of the business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(9)</td>
<td>+2,000</td>
<td></td>
<td>Owner withdrawal</td>
</tr>
<tr>
<td>Bal.</td>
<td>21,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(10)</td>
<td>+22,000</td>
<td>–22,000</td>
<td></td>
</tr>
<tr>
<td>Bal.</td>
<td>43,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(11)</td>
<td>–2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal.</td>
<td>41,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Objective 6: Prepare and evaluate the financial statements
Statement of Owner's Equity  The statement of owner's equity presents a summary of the changes that occurred in the entity's owner's equity during a specific period of time, such as a month or a year.

Increases in owner’s equity arise from:

- Owner investments
- Net income (revenues exceed expenses)

Decreases in owner’s equity arise from:

- Owner withdrawals
- Net loss (expenses exceed revenues)

Net income or net loss comes directly from the income statement. Owner investments and withdrawals are capital transactions between the business and its owner, so they do not affect the income statement.

Balance Sheet  The balance sheet lists all the assets, liabilities, and owner’s equity of an entity as of a specific date, usually the end of a month or a year. The balance sheet is like a snapshot of the entity. For this reason, it is also called the statement of financial position.

Cash Flow Statement  The cash flow statement reports the cash coming in (cash receipts) and the cash going out (cash payments or disbursements) during a period. Business activities result in a net cash inflow (receipts greater than payments) or a net cash outflow (payments greater than receipts). The cash flow statement shows the net increase or decrease in cash during the period and the cash balance at the end of the period. We focus on the cash flow statement in Chapter 17.

Computers and software programs have had a significant impact on the preparation of the financial statements. Financial statements can be produced instantaneously after the data from the financial records are entered into the computer. Of course, in manual and computerized accounting systems, any errors that occur in the financial records will be passed on to the financial statements. For this reason, the person responsible for analyzing the accounting data is critical to the accuracy of the financial statements.

Financial Statement Headings  Each financial statement has a heading, which gives three pieces of data:

- The proper name of the business (in our discussion SuperTravel)
- The full name of the particular statement
- The date or time period covered by the statement


An income statement or a statement of owner’s equity covering a year ending on December 31, 2007, is dated “For the Year Ended December 31, 2007.” A monthly income statement or statement of owner’s equity for September 2008 has in its heading “For the Month Ended September 30, 2008” or simply “For the Month of September 2008.” Income must be identified with a particular time period.
STOP AND THINK

Why does the income statement and statement of owner’s equity have to be dated for a particular time period?

**Answer:** If December 31, 2007, appeared in the heading of these statements, you would not know whether the net income amount was good or bad if you do not know the time period covered by the statements. The net income amount could be good if the time period was one day, but it could be bad if the time period was one year.

Relationships among the Financial Statements

Exhibit 1–10 on page 22 illustrates all four financial statements. Their data come from the transaction analysis in Exhibit 1–9. We are assuming the transactions occurred during the month of April 2007. Study the exhibit carefully, because it shows the relationships among the four financial statements.

Observe the following in Exhibit 1–10:

1. The *income statement* for the month ended April 30, 2007
   a. Reports all *revenues* and all *expenses* during the period. Expenses are often listed alphabetically, but can also be listed in decreasing order of amount, with the largest expense first.
   b. Reports *net income* of the period if total revenues exceed total expenses, as in the case of SuperTravel’s operations for April. If total expenses exceed total revenues, a *net loss* is reported instead.

2. The *statement of owner’s equity* for the month ended April 30, 2007
   a. Opens with the owner’s capital balance at the beginning of the period.
   b. Adds *investment by the owner* and adds *net income* (or subtracts *net loss*, as the case may be). Net income (or net loss) comes directly from the income statement (see arrow ① in Exhibit 1–10).
   c. Subtracts *withdrawals by the owner*. The parentheses around an amount indicate a subtraction.
   d. Ends with the owner’s capital balance at the end of the period.

3. The *balance sheet* at April 30, 2007, the end of the period
   a. Reports all *assets*, all *liabilities*, and *owner’s equity* of the business at the end of the period.
   b. Reports that total assets equal the sum of total liabilities plus total owner’s equity.
   c. Reports the owner’s ending capital balance, taken directly from the statement of owner’s equity (see arrow ②).

4. The *cash flow statement* for the month ended April 30, 2007
   a. Reports cash flows from three types of business activities (*operating*, *investing*, and *financing* activities) during the month. Each category of cash-flow activities includes both cash receipts, which are positive amounts, and cash payments, which are negative amounts (denoted by parentheses). Each category results in a net cash inflow or a net cash outflow for the period. We discuss these categories in detail in Chapter 17.
   b. Reports a net increase in cash during the month and ends with the cash balance at April 30, 2007. This is the amount of cash to report on the balance sheet (see arrow ③).
### SUPERTRAVEL

#### Income Statement

**For the Month Ended April 30, 2007**

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$11,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service revenue</td>
<td>$11,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent expense</td>
<td>$2,200</td>
</tr>
<tr>
<td>Salary expense</td>
<td>2,400</td>
</tr>
<tr>
<td>Utilities expense</td>
<td>600</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>5,200</td>
</tr>
</tbody>
</table>

| Net income         | $5,800  |

### SUPERTRAVEL

#### Statement of Owner’s Equity

**For the Month Ended April 30, 2007**

| John Lapp, capital, April 1, 2007 | $0 |
| Add: Investment by owner          | 60,000 |
| Net income for the month           | 5,800 |
| **John Lapp, capital, April 30, 2007** | $63,800 |

| Less: Withdrawals by owner         | (2,000) |

### SUPERTRAVEL

#### Balance Sheet

**April 30, 2007**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$41,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,000</td>
</tr>
<tr>
<td>Office supplies</td>
<td>1,000</td>
</tr>
<tr>
<td>Land</td>
<td>18,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$64,000</strong></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$200</td>
</tr>
<tr>
<td><strong>Owner’s Equity</strong></td>
<td></td>
</tr>
<tr>
<td>John Lapp, capital</td>
<td>63,800</td>
</tr>
<tr>
<td><strong>Total liabilities and</strong></td>
<td><strong>$64,000</strong></td>
</tr>
<tr>
<td><strong>owner’s equity</strong></td>
<td></td>
</tr>
</tbody>
</table>

### SUPERTRAVEL

#### Cash Flow Statement*

**For the Month Ended April 30, 2007**

<table>
<thead>
<tr>
<th>Cash flows from operating activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash collections from customers**</td>
<td>$7,000</td>
</tr>
<tr>
<td>Cash payments to suppliers***</td>
<td>(3,600)</td>
</tr>
<tr>
<td>Cash payments to employees</td>
<td>(2,400)</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>(6,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from investing activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition of land</td>
<td>$(40,000)</td>
</tr>
<tr>
<td>Proceeds from sale of land</td>
<td>22,000</td>
</tr>
<tr>
<td><strong>Net cash outflow from investing activities</strong></td>
<td>$(18,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from financing activities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment by owner</td>
<td>$60,000</td>
</tr>
<tr>
<td>Withdrawal by owner</td>
<td>(2,000)</td>
</tr>
<tr>
<td><strong>Net cash inflow from financing activities</strong></td>
<td>58,000</td>
</tr>
</tbody>
</table>

| Net increase in cash                 | $41,000 |
| Cash balance, April 1, 2007          | 0       |
| Cash balance, April 30, 2007         | $41,000 |

---

*Chapter 17 explains how to prepare this statement.

**$5,000 + $2,000 = $7,000$

***$2,200 + $600 + $800 = $3,600$
As we conclude this chapter, we return to our opening question: Why is accounting and the business environment important? The Decision Guidelines feature below summarizes the chapter by examining examples of business decisions that are made. The chapter-opening questions are answered here. A Decision Guidelines feature appears in each chapter of this book. The Decision Guidelines serve as useful summaries of the decision-making process and its foundation in accounting information.

STOP AND THINK

Study Exhibit 1–10, which gives the financial statements for SuperTravel at April 30, 2007, the end of the first month of operations. Answer these questions for SuperTravel to evaluate the business’s results.

1. What was the business’s result of operations for the month of April—a net income (profit) or a net loss, and how much? Which financial statement provides this information?

2. How much revenue did the business earn during April? What was the business’s largest expense? How much were total expenses?

3. Is the income statement dated at the last day of the period or for the entire period? Why?

4. How much owner capital did the company have at the beginning of April? At the end of April? Identify all the items that changed owner capital during the month, along with their amounts. Which financial statement provides this information?

5. How much cash does the company have as it moves into the next month—that is, May 2007? Which financial statement provides this information?

6. How much do clients owe SuperTravel at April 30? Is this an asset or a liability for the business? What does the business call this item?

7. How much does the business owe outsiders at April 30? Is this an asset or a liability for the business? What does the business call this item?

8. How is the balance sheet dated? Why is it dated this way? Why does the balance sheet’s date differ from the date on the income statement?

Answers:

1. Net income = $5,800. The income statement provides this information.

2. From the income statement: Total revenue = $11,000. Salary was the largest expense, at $2,400. Total expenses = $5,200.

3. The income statement is dated “For the Month Ended April 30, 2007.” The income statement is dated for the entire period because the revenues and the expenses occurred during the month, not at the end of the month. The income statement reports on the business’s operations during the whole span of the period.

4. From the statement of owner’s equity:
   Beginning owner capital = $0 Ending owner capital = $63,800
   Increases: Investment by owner = $60,000; Net income for the month = $5,800
   Decrease: Withdrawal by owner = $2,000

5. Cash = $41,000. The balance sheet or cash flow statement provides this information.

6. Clients owe the business $4,000, which is an asset called Accounts Receivable.

7. The business owes outsiders $200, which is a liability called Accounts Payable.

8. The balance sheet is dated April 30, 2007, which means at midnight on April 30, 2007. The balance sheet is dated at a single moment in time (in this case, April 30, 2007) to show the amount of assets, liabilities, and owner’s equity the business had on that date. The balance sheet is like a snapshot, while the income statement provides a moving picture of the business through time.
<table>
<thead>
<tr>
<th>Decision</th>
<th>Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>How should we organize a business?</td>
<td>If a single owner, but not incorporated — a <strong>proprietorship</strong>.</td>
</tr>
<tr>
<td></td>
<td>If two or more owners, but not incorporated — a <strong>partnership</strong>.</td>
</tr>
<tr>
<td></td>
<td>If the business issues shares of stock to shareholders — a <strong>corporation</strong>.</td>
</tr>
<tr>
<td>What should we account for?</td>
<td>Account for the business, which is a separate entity apart from its owner (Economic-entity assumption). Account for transactions and events that affect the business <strong>and</strong> can be measured objectively. (Reliability characteristic.)</td>
</tr>
<tr>
<td>How much should we record for assets and liabilities?</td>
<td>Actual historical amount (Cost principle).</td>
</tr>
<tr>
<td>How to analyze a transaction?</td>
<td>Use accounting equation:</td>
</tr>
<tr>
<td></td>
<td>[ \text{ASSETS} = \text{LIABILITIES} + \text{OWNER'S EQUITY} ]</td>
</tr>
<tr>
<td></td>
<td>Note: Owner's equity is called shareholders' equity if the entity is a corporation.</td>
</tr>
<tr>
<td>How do we measure profits and losses?</td>
<td>Income statement:</td>
</tr>
<tr>
<td></td>
<td>[ \text{REVENUES} - \text{EXPENSES} = \text{NET INCOME (or NET LOSS)} ]</td>
</tr>
<tr>
<td>Did owner's equity increase or decrease?</td>
<td>Statement of owner's equity:</td>
</tr>
</tbody>
</table>
|                                                                          | \begin{align*} \text{Beginning capital} \\
|                                                                          | + \text{Owner investments} \\
|                                                                          | + \text{Net income (or } - \text{ Net loss)} \\
|                                                                          | = \text{Ending capital} \end{align*}                                  |
| Where does the business stand financially?                              | Balance sheet (accounting equation):                                     |
|                                                                          | \[ \text{ASSETS} = \text{LIABILITIES} + \text{OWNER'S EQUITY} \]          |
|                                                                          | Income statement                                                          |
| How did the owner's investment change over the period?                   | Statement of owner's equity                                               |
| Where did the business's cash come from?                                | Cash flow statement:                                                     |
|                                                                          | \begin{align*} \text{Operating activities: Net cash inflow (or outflow)} \\
|                                                                          | + \text{Investing activities: Net cash inflow (or outflow)} \\
|                                                                          | + \text{Financing activities: Net cash inflow (or outflow)} \\
|                                                                          | = \text{Net increase (decrease) in cash} \end{align*}                    |
Summary Problem for Your Review

Lynn Rani opens an apartment locator business in Edmonton. She is the sole owner of the proprietorship, which she names Fast Apartment Locators. During the first month of operations, July 2007, the following transactions occurred:

a. Rani invests $50,000 of personal funds to start the business.
b. The business purchases, on account, office supplies costing $800.
c. Fast Apartment Locators pays cash of $40,000 to acquire a parcel of land. The business intends to use the land as a future building site for its business office.
d. The business locates apartments for clients and receives cash of $4,000.
e. The business pays $400 on the account payable created in Transaction (b).
f. Lynn Rani pays $3,000 of personal funds for a vacation for her family.
g. The business pays cash expenses for office rent, $1,000, and utilities, $300.
h. The business returns to the supplier office supplies that cost $200. The wrong supplies were shipped.
i. Lynn Rani withdraws $1,500 cash for personal use.

Required

1. Analyze the preceding transactions in terms of their effects on the accounting equation of Fast Apartment Locators. Use Exhibit 1–9 as a guide but show balances only after the last transaction.

2. Prepare the income statement, statement of owner’s equity, and balance sheet of Fast Apartment Locators after recording the transactions. Use Exhibit 1–10 as a guide.

Solution

1. Panel A: Details of Transactions
   a. Rani invested $50,000 cash to start the business.
   b. Purchased $800 in office supplies on account.
   c. Paid $40,000 to acquire land as a future building site.
   d. Earned service revenue and received cash of $4,000.
   e. Paid $400 on account.
   f. Paid for a personal vacation, which is not a transaction of the business.
   g. Paid cash expenses for rent, $1,000, and utilities, $300.
   h. Returned office supplies that cost $200.
   i. Withdrew $1,500 cash for personal use.
For each transaction, make sure the accounting equation Assets = Liabilities + Owner's Equity balances before going on to the next transaction.

### Panel B: Analysis of Transactions

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner's Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Office Supplies + 50,000</td>
<td></td>
<td>+ 800</td>
</tr>
<tr>
<td>(b)</td>
<td>Office Supplies + 800</td>
<td>+ 4,000</td>
<td></td>
</tr>
<tr>
<td>(c)</td>
<td>Office Supplies + 40,000</td>
<td>- 400</td>
<td>- 1,000</td>
</tr>
<tr>
<td>(d)</td>
<td>Office Supplies - 400</td>
<td>+ 40,000</td>
<td>+ 1,500</td>
</tr>
<tr>
<td>(e)</td>
<td>Land + 10,800</td>
<td>- 200</td>
<td>- 1,500</td>
</tr>
<tr>
<td>(f)</td>
<td>Land + 600</td>
<td>- 300</td>
<td></td>
</tr>
<tr>
<td>(g)</td>
<td>Land + 40,000</td>
<td>- 40,000</td>
<td></td>
</tr>
<tr>
<td>(h)</td>
<td>Bal. 10,800</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i)</td>
<td>Bal. 600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(j)</td>
<td>Bal. 40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k)</td>
<td>Bal. 51,400</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 2. Financial Statements of Fast Apartment Locators

**FAST APARTMENT LOCATORS**

**Income Statement**

For the Month Ended July 31, 2007

| Revenue: | $4,000 |
| Service revenue | |

| Expenses: | $1,300 |
| Rent expense | $1,000 |
| Utilities expense | 300 |
| Total expenses | |

**Net Income**: $2,700

**Statement of Owner's Equity**

For the Month Ended July 31, 2007

| Lynn Rani, capital, July 1, 2007 | $0 |
| Add: Investment by owner | 50,000 |
| Add: Net income for July | 2,700 |
| Less: Withdrawal by owner | 1,500 |
| Lynn Rani, capital, July 31, 2007 | $51,200 |

**Balance Sheet**

For the Month Ended July 31, 2007

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,800</td>
</tr>
<tr>
<td>Office supplies</td>
<td>600</td>
</tr>
<tr>
<td>Land</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$51,400</strong></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$200</td>
</tr>
<tr>
<td><strong>Owner's Equity</strong></td>
<td></td>
</tr>
<tr>
<td>Lynn Rani, capital</td>
<td>51,200</td>
</tr>
<tr>
<td><strong>Total liabilities and owner's equity</strong></td>
<td><strong>$51,400</strong></td>
</tr>
</tbody>
</table>
1. Define accounting, and describe the users of accounting information. Accounting is an information system for measuring, processing, and communicating financial information. As the “language of business,” accounting helps a wide range of users make business decisions. Examples of users include individual investors, businesses, government agencies, and lenders.

2. Explain why ethics and rules of conduct are crucial in accounting and business. Ethical considerations affect all areas of accounting and business. Users need relevant and reliable information about companies to make decisions. The professional accounting groups in Canada have codes of ethics and rules of conduct to assure society that accountants behave ethically.

3. Describe and discuss the forms of business organizations. The three basic forms of business organizations are the proprietorship, the partnership, and the corporation. A summary and comparison of the three forms are given in Exhibit 1–5 on page 8. Limited-liability partnerships (LLPs) and limited-liability companies (LLCs) are special forms of partnerships and proprietorships.

4. Explain the development of accounting standards, and describe the concepts and principles. Generally accepted accounting principles (GAAP) guide accountants in their work. They are developed by the Accounting Standards Board (AcSB) of the CICA and published in the CICA Handbook. For example, accountants use the economic-entity assumption to keep the business’s records separate from the records of other economic units. Other important guidelines or standards are the reliability characteristic, the cost principle, the going-concern assumption, and the stable-monetary-unit assumption.

5. Describe and use the accounting equation to analyze business transactions. In its most common form, the accounting equation is

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

A transaction is an event that affects the financial position of an entity and can be reliably recorded. Transactions affect a business’s assets, liabilities, and owner’s equity. Therefore, transactions are often analyzed in terms of their effect on the accounting equation.

6. Prepare and evaluate the financial statements. The financial statements communicate information for decision making by an entity’s users, including managers, owners, and creditors. The income statement summarizes the entity’s operations in terms of revenues earned and expenses incurred during a specific period of time. Total revenues minus total expenses equal net income. The statement of owner’s equity reports the changes in owner’s equity during the period. The balance sheet lists the entity’s assets, liabilities, and owner’s equity at a specific date. The cash flow statement reports the changes in cash during the period.

High net income indicates success in business; a net loss indicates a lack of success in business.

Self-Study Questions

Test your understanding of the chapter by marking the correct answer for each of the following questions:

1. The organization that formulates generally accepted accounting principles is the (p. 8)
   a. Ontario Securities Commission
   b. Public Accountants Council of Canada
   c. Canadian Institute of Chartered Accountants (CICA)
   d. Canada Revenue Agency (CRA)

2. Which of the following forms of business organization is an “artificial person” and must obtain legal approval from the federal government or a province to conduct business? (p. 7)
   a. Law firm
   b. Proprietorship
   c. Partnership
   d. Corporation

3. You have purchased some T-shirts for $1,000 and can sell them immediately for $1,500. What accounting assumption or principle governs the amount at which to record the goods you purchased? (p. 11)
   a. Economic-entity assumption
   b. Reliability characteristic
   c. Cost principle
   d. Going-concern assumption

4. The economic resources of a business are called (p. 12)
   a. Assets
   b. Liabilities
   c. Owner’s equity
   d. Accounts payable

5. If the assets of a business are $174,300 and the liabilities are $82,000, how much is the owner’s equity? (p. 13)
   a. $256,300
   b. $92,300
   c. $174,300
   d. $82,000

6. A business has assets of $60,000 and liabilities of $140,000. How much is its owner’s equity? (p. 13)
   a. $0
   b. ($80,000)
   c. $80,000
   d. $200,000

7. If the owner’s equity in a business is $22,000 and the liabilities are $36,000, how much are the assets? (p. 13)
   a. $22,000
   b. $14,000
   c. $58,000
   d. $36,000

8. Purchasing office supplies on account will (p. 14)
   a. Increase an asset and increase a liability
   b. Increase an asset and increase owner’s equity
   c. Increase one asset and decrease another asset
   d. Increase an asset and decrease a liability
9. Performing a service for a customer or client and the immediate receiving of cash will (p. 15)
   a. Increase one asset and decrease another asset
   b. Increase an asset and increase owner’s equity
   c. Decrease an asset and decrease a liability
   d. Increase an asset and increase a liability

10. Paying an account payable (p. 16)
    a. Increase one asset and decrease another asset
    b. Decrease an asset and decrease owner’s equity
    c. Decrease an asset and decrease a liability
    d. Increase an asset and increase a liability

11. The financial statement that summarizes assets, liabilities, and owner’s equity is called (p. 20)
    a. Cash flow statement
    b. Balance sheet
    c. Income statement
    d. Statement of owner’s equity

12. The financial statements that are dated for a time period (rather than for a specific point in time) are the (pp. 18–20)
    a. Balance sheet and income statement
    b. Balance sheet and statement of owner’s equity
    c. Income statement, statement of owner’s equity, and cash flow statement
    d. All financial statements are dated for a time period.

Answers to the Self-Study Questions follow the Similar Accounting Terms.

**Accounting Vocabulary**

Like many other subjects, accounting has a special vocabulary. It is important that you understand the following terms. They are explained in the chapter and also in the glossary at the end of the book.

- account payable (p. 15)
- account receivable (p. 16)
- accounting (p. 2)
- accounting equation (p. 12)
- asset (p. 12)
- audit (p. 5)
- balance sheet (p. 20)
- capital (p. 12)
- cash flow statement (p. 20)
- corporation (p. 7)
- cost principle (p. 11)
- entity (p. 10)
- expense (p. 13)
- financial accounting (p. 4)
- financial statements (p. 2)
- generally accepted accounting principles (GAAP) (p. 8)
- going-concern assumption (p. 11)
- income statement (p. 19)
- liability (p. 12)
- limited-liability company (LLC) (p. 8)
- limited-liability partnership (LLP) (p. 8)
- management accounting (p. 4)
- net earnings (p. 19)
- net income (p. 19)
- net loss (p. 19)
- net profit (p. 19)
- note payable (p. 15)
- objectivity characteristic (p. 10)
- owner’s equity (p. 12)
- owner withdrawals (p. 13)
- partnership (p. 7)
- proprietorship (p. 7)
- reliability characteristic (p. 10)
- revenue (p. 13)
- shareholder (p. 7)
- stable-monetary-unit assumption (p. 11)
- statement of earnings (p. 19)
- statement of financial position (p. 20)
- statement of operations (p. 19)
- statement of owner’s equity (p. 19)
- transaction (p. 13)

**Similar Accounting Terms**

<table>
<thead>
<tr>
<th>Accounting equation</th>
<th>Assets = Liabilities + Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet</td>
<td>Statement of Financial Position</td>
</tr>
<tr>
<td>Income Statement</td>
<td>Statement of Operations; Statement of Earnings</td>
</tr>
<tr>
<td>Net income</td>
<td>Net earnings; Net profit</td>
</tr>
</tbody>
</table>

**Answers to Self-Study Questions**

1. c 3. c 5. b 7. c 9. b 11. b 2. d 4. a 6. b 8. a 10. c 12. c
Questions

1. Distinguish between accounting and bookkeeping.
2. Identify five users of accounting information and explain how they use it.
3. Name two important historical reasons for the development of accounting.
4. Name three professional designations of accountants. Also give their abbreviations.
5. What organization formulates generally accepted accounting principles? Is this organization a government agency?
6. Identify the owner(s) of a proprietorship, a partnership, and a corporation.
7. Why do ethical standards exist in accounting? Which professional organizations direct their standards more toward independent auditors? Which organizations direct their standards more toward management accountants?
8. Why is the economic-entity assumption so important to accounting?
9. Give four examples of types of accounting entities.
10. Briefly describe the reliability characteristic.
11. What role does the cost principle play in accounting?
12. If assets = liabilities + owner’s equity, then how can liabilities be expressed?
13. Explain the difference between an account receivable and an account payable.
14. What role do transactions play in accounting?
15. A company reported monthly revenues of $87,600 and expenses of $91,300. What is the result of operations for the month?
17. What feature of the balance sheet gives this financial statement its name?
18. Give another title for the income statement.
19. Which financial statement is like a snapshot of the entity at a specific time? Which financial statement is like a video of the entity’s operation during a period of time?
20. What information does the statement of owner’s equity report?
21. Give another term for the owner’s equity of a proprietorship.
22. What piece of information flows from the income statement to the statement of owner’s equity? What information flows from the statement of owner’s equity to the balance sheet? What balance sheet item is explained by the cash flow statement?

Starters

Starter 1–1 What is accounting, and why is accounting information important?

Starter 1–2 Refer to the Student Policies, Bylaws, and Codes of Conduct of your college or university. Why do these policies exist?

Starter 1–3 Alexis Andrews wants to start a business renting kayaks to tourists over the Internet. She is not sure whether she needs to incorporate to begin operations. Advise Alexis on the forms of business organizations that exist, and suggest one that would suit her needs.

Starter 1–4 List the major categories of accounts that appear on the balance sheet, and describe a typical heading for this statement.

Starter 1–5 List the major categories of accounts that appear on the income statement, and describe a typical heading for this statement.

Starter 1–6 What are generally accepted accounting principles?
Starter 1–7 Match the assumption, principle, or constraint description with the appropriate term by placing a, b, c, d, e, and f on the appropriate line.

- a. Cost principle ______ Benefits of the information produced by an accounting system must be greater than the costs
- b. Going-concern assumption ______ Amounts may be ignored if the effect on a decision maker’s decision is not significant
- c. Stable-monetary-unit assumption ______ Transactions recorded based on cash amount received or paid
- d. Economic-entity assumption ______ Transactions are expressed using units of money
- e. Cost/benefit constraint ______ Assumes that a business is going to continue operations indefinitely
- f. Materiality constraint ______ Business must keep its accounting records separate from its owner’s accounting records

Starter 1–8 Suppose Alexis Andrews Kayaks purchased a storage building for the kayaks for $100,000, and financed the purchase with a loan of $75,000 and an investment by the owner for the remainder. Use the accounting equation to calculate the owner’s equity amount.

Starter 1–9 A customer in the United States is extremely interested in renting a number of products from Alexis Andrews Kayaks and e-mails his intention to rent kayaks in the summer. Would an accountant consider this event a transaction to be recorded in the accounting records? Explain.

Starter 1–10 What are the four main financial statements that are provided in a company’s annual report? Examples of two companies’ annual reports are provided in Appendix A and Appendix B at the back of this textbook.

Exercises

Exercise 1–1 Shortly after starting Red River Express Company you realize the company needs a bank loan to purchase office equipment. To prepare for the loan request, you review some basic accounting concepts. In your own words define assets, liabilities, and owner’s equity. What is the relationship among assets, liabilities, and owner’s equity?

Exercise 1–2 Raymond and Lupita Rodriguez want to open a Mexican restaurant in Winnipeg. In need of cash, they ask TD Canada Trust for a loan. With little knowledge of finance, Raymond and Lupita don’t know how the lending process works. Explain to them the information provided to the bank by the income statement (statement of operations) and the balance sheet (statement of financial position). Indicate why a lender would require this information.

Exercise 1–3 Fill in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Owners(s)</th>
<th>Life of organization</th>
<th>Personal liability of owner(s) for business debts</th>
<th>Legal status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietorship</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partnership</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Exercise 1–4 Give an example of a business transaction that has each of the following effects on the accounting equation:

- a. Increases an asset and increases a liability.
- b. Increases one asset and decreases another asset.
c. Decreases an asset and decreases owner's equity.
d. Decreases an asset and decreases a liability.
e. Increases an asset and increases owner’s equity.

**Exercise 1–5**
Chang Enterprises, a business owned by Sophie Chang, experienced the following events. State whether each event (1) increased, (2) decreased, or (3) had no effect on the total assets of the business. Identify any specific asset affected.
a. Sophie Chang increased her cash investment in the business.
b. Paid cash on accounts payable.
c. Purchased office equipment; signed a note payable in payment.
d. Performed service for a customer on account.
e. Sophie Chang withdrew cash for personal expenses.
f. Received cash from a customer on account receivable.
g. Sophie Chang used personal funds to purchase a swimming pool for her home.
h. Sold undesirable land for a price equal to the cost of the land; received cash.
i. Borrowed money from the bank.

**Exercise 1–6**
Compute the missing amount in the accounting equation of each of the following three entities:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business A</td>
<td>$ ?</td>
<td>$60,000</td>
</tr>
<tr>
<td>Business B</td>
<td>72,000</td>
<td>?</td>
</tr>
<tr>
<td>Business C</td>
<td>100,000</td>
<td>79,000</td>
</tr>
</tbody>
</table>

**Exercise 1–7**
Theresa Hanson owns Common Grounds Coffee House, near the campus of Western College. The company has cash of $14,000 and furniture that cost $34,000. Debts include accounts payable of $12,000 and a $24,000 note payable. Write the accounting equation of Common Grounds Coffee House. What is the owner’s equity of the company?

**Exercise 1–8**
Diamond Works, a mineral exploration and development company in Vancouver, had total assets of $140 million and total liabilities of $70 million at January 31, 2007. At the company’s year end on January 31, 2008, Diamond Works’s total assets were $137 million and total liabilities were $9 million.

**Required**
1. Did the owner’s equity of Diamond Works increase during the period February 1, 2007, to January 31, 2008? By how much?
2. Identify two possible reasons for the change in owner’s equity of Diamond Works during the period February 1, 2007, to January 31, 2008.

**Exercise 1–9**
Indicate the effects of the following business transactions on the accounting equation of a proprietorship. Transaction a is answered as a guide.
a. Received $20,000 cash from the owners.
   *Answer:* Increase asset (Cash)
   Increase owner’s equity (Owner, Capital)
b. Paid the current month’s office rent of $2,000.
c. Paid $2,700 cash to purchase office supplies.
d. Performed engineering service for a client on account, $3,000.
e. Purchased on account office furniture at a cost of $2,000.
f. Received cash on account, $2,000.
g. Paid cash on account, $1,000.
h. Sold land for $15,000, which was the business’s cost of the land.
i. Performed engineering services for a client and received cash of $2,000.

Exercise 1–10
Doug Mossley, M.D., opens a medical clinic. During his first month of operation, January, the clinic, entitled Austin Heights Clinic, experienced the following events:

Jan. 6 Mossley invested $170,000 in the clinic by opening a bank account in the name of Austin Heights Clinic.
9 Austin Heights Clinic paid cash for land costing $162,500. There are plans to build a clinic on the land. Until then, the business will rent an office.
12 The clinic purchased medical supplies for $5,300 on account.
15 On January 15, Austin Heights Clinic officially opened for business.
15–31 During the rest of the month, the clinic earned professional fees of $12,000 and received cash immediately.
28 The clinic sold supplies to another clinic at cost for $750.
31 The clinic paid $2,250 on account.

Required
Analyze the effects of these events on the accounting equation of Austin Heights Clinic. Use a format similar to that of Exhibit 1–9, Panel B, on page 19 with headings for: Cash; Medical Supplies; Land; Accounts Payable; and Doug Mossley, Capital.

Exercise 1–11
The analysis of the transactions that Penfild Equipment Rental engaged in during its first month of operations follows. The business buys electronic equipment that it rents out to earn rental revenue. The owner of the business, Steve Penfild, made only one investment to start the business and made no withdrawals from Penfild Equipment Rental.

<table>
<thead>
<tr>
<th>Cash</th>
<th>Accounts Receivable</th>
<th>Rental Equipment</th>
<th>Accounts Payable</th>
<th>S. Penfild, Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. +25,000</td>
<td></td>
<td></td>
<td></td>
<td>+25,000</td>
</tr>
<tr>
<td>b. + 375</td>
<td></td>
<td></td>
<td></td>
<td>+ 375</td>
</tr>
<tr>
<td>c.</td>
<td>+ 400</td>
<td></td>
<td></td>
<td>+ 400</td>
</tr>
<tr>
<td>d.</td>
<td></td>
<td>+60,000</td>
<td>+60,000</td>
<td></td>
</tr>
<tr>
<td>e. − 500</td>
<td></td>
<td></td>
<td>− 500</td>
<td></td>
</tr>
<tr>
<td>f. + 3,800</td>
<td></td>
<td></td>
<td></td>
<td>+ 3,800</td>
</tr>
<tr>
<td>g. + 75</td>
<td>− 75</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>h. − 6,000</td>
<td></td>
<td></td>
<td>− 6,000</td>
<td></td>
</tr>
</tbody>
</table>

Required
1. Describe each transaction of Penfild Equipment Rental.
2. If these transactions fully describe the operations of Penfild Equipment Rental during the month, what was the amount of net income or net loss?

Exercise 1–12
Presented below are the balances of the assets and liabilities of Whitehead Consulting Services as of September 30, 2007. Also included are the revenue and expense account balances of the business for September. Darlene Whitehead, the owner, invested $30,000 when the business was formed.
Consulting service revenue................. $45,500
Accounts receivable.................. 34,500
Accounts payable...................... 18,750
Salary expense.......................... 10,000
D. Whitehead, Capital............... ?

Computer equipment ................. $77,500
Supplies.................................. 4,000
Note payable.......................... 36,000
Rent expense........................... 3,500
Cash........................................ 3,750

Required
1. What type of business entity or organization is Whitehead Consulting Services? How can you tell?
3. What does the balance sheet report—financial position or operating results? Which financial statement reports the other information?

Exercise 1–13
Examine Exhibit 1–9 on page 19. The exhibit summarizes the transactions of SuperTravel for the month of April 2007. Suppose the business completed transactions 1 to 7 and needed a bank loan on April 21, 2007. The vice-president of the bank requires financial statements to support all loan requests.

Required  Prepare the income statement, statement of owner’s equity, and balance sheet that SuperTravel would present to the banker on April 21, 2007, after completing the first seven transactions. Exhibit 1–10, page 22, shows the format of these financial statements.

Exercise 1–14
The assets, liabilities, owner’s equity, revenue and expenses of Maclean Company, a proprietorship, have the following balances at December 31, 2007, the end of its first year of business. During the year the proprietor, Nancy Maclean, invested $45,000 in the business.

Note payable.......................... $ 63,000
Utilities expense ...................... 10,400
Accounts payable...................... 9,900
N. Maclean, capital.................. 63,000
Service revenue ...................... 543,600
Accounts receivable................ 27,000
Supplies expense...................... 24,000
Equipment.............................. 30,000

Office furniture.................. $ 105,000
Rent expense........................ 24,000
Cash......................................... 10,800
Office supplies.................. 14,400
Salary expense .................. 165,000
Salary payable.................. 6,000
Salary tax expense.................. 4,200
N. Maclean, withdrawals........... ?

Required
1. Prepare the income statement of Maclean Company for the year ended December 31, 2007. What is Maclean Company’s net income or net loss for 2007? (Hint: Ignore balance sheet items.)
2. What was the total amount of Nancy Maclean’s withdrawals during the year?

Exercise 1–15
The 2005 annual report of Bombardier Inc. reported revenue of $15,839 million. Total expenses for the year were $15,787 million. Bombardier ended the year with $20,080 million in total assets and $17,782 million in total liabilities.

During 2004, Bombardier earned income from continuing operations (net income) of $311 million. At the end of 2004, Bombardier reported total assets of $19,277 million and total liabilities of $16,827 million.

Required
1. Compute Bombardier’s income from continuing operations (net income) for 2005. Did income increase or decrease from 2004 to 2005? By how much?
2. Did Bombardier’s shareholders’ equity (which is the owner’s equity of a corporation) increase or decrease during 2005? By how much?


**Challenge Exercise**

**Exercise 1–16**

Compute the missing amounts for each of the following businesses.

<table>
<thead>
<tr>
<th></th>
<th>Yew Co.</th>
<th>Ash Co.</th>
<th>Arbutus Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>$220,000</td>
<td>$100,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>100,000</td>
<td>40,000</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>Ending:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>$320,000</td>
<td>$140,000</td>
<td>$ ?</td>
</tr>
<tr>
<td>Liabilities</td>
<td>140,000</td>
<td>70,000</td>
<td>160,000</td>
</tr>
<tr>
<td><strong>Owner’s equity:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investments by owner</td>
<td>$ ?</td>
<td>$ 0</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Withdrawals by owner</td>
<td>220,000</td>
<td>80,000</td>
<td>140,000</td>
</tr>
<tr>
<td><strong>Income Statement:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues</td>
<td>$440,000</td>
<td>$210,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>320,000</td>
<td>?</td>
<td>300,000</td>
</tr>
</tbody>
</table>

**Exercise 1–17**

Oriole Travel Company’s balance sheet data are shown below.

<table>
<thead>
<tr>
<th></th>
<th>January 1, 2007</th>
<th>December 31, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$150,000</td>
<td>$195,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>109,000</td>
<td>131,000</td>
</tr>
</tbody>
</table>

**Required**

1. Compute the amount of net income or net loss for the company during the year ended December 31, 2007, if the owner invested $39,000 in the business and withdrew $6,000 during the year. Show all calculations.

2. Prepare the statement of owner’s equity for Mary Jones, the owner of Oriole Travel Company, for the year ended December 31, 2007. Use the format shown in Exhibit 1–10 on page 22.

**Beyond the Numbers**

**Beyond the Numbers 1-1**

As an analyst for CIBC, it is your job to write recommendations to the bank’s loan committee. Softon Engineering Co., a client of the bank, has submitted these summary data to support the company’s request for a $200,000 loan:

<table>
<thead>
<tr>
<th>Income Statement Data</th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>$445,000</td>
<td>$415,000</td>
<td>$410,000</td>
</tr>
<tr>
<td>Total expenses</td>
<td>320,000</td>
<td>285,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$125,000</td>
<td>$130,000</td>
<td>$140,000</td>
</tr>
</tbody>
</table>
Chapter 1
Accounting and the Business Environment

Statement of Owner’s Equity Data

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning capital</td>
<td>$190,000</td>
<td>$200,000</td>
<td>$195,000</td>
</tr>
<tr>
<td>Add: Net income</td>
<td>$125,000</td>
<td>$130,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>Less: Withdrawals</td>
<td>$(145,000)</td>
<td>$(140,000)</td>
<td>$(135,000)</td>
</tr>
<tr>
<td>Ending capital</td>
<td>$170,000</td>
<td>$190,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Balance Sheet Data

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$365,000</td>
<td>$360,000</td>
<td>$330,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$195,000</td>
<td>$170,000</td>
<td>$130,000</td>
</tr>
<tr>
<td>Total owner’s equity</td>
<td>170,000</td>
<td>190,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Total liabilities and owner’s equity</td>
<td>$365,000</td>
<td>$360,000</td>
<td>$330,000</td>
</tr>
</tbody>
</table>

Required  Analyze these financial statement data to decide whether the bank should lend $200,000 to Softon Engineering Co. Consider the trends in net income and owner’s equity and the change in total liabilities in making your decision. Write a one-paragraph recommendation to the bank’s loan committee.

Beyond the Numbers 1–2

White Pine Camp conducts summer camps for children with physical challenges. Because of the nature of its business, White Pine Camp experiences many unusual transactions. Evaluate each of the following transactions in terms of its effect on White Pine Camp’s income statement and balance sheet.

a. A camper suffered a dental injury that was not covered by insurance. White Pine Camp paid $500 for the child’s dental care. How does this transaction affect the income statement and the balance sheet?

b. One camper’s mother is a physician. White Pine Camp allows this child to attend camp in return for the mother’s serving part-time in the camp infirmary for the two-week term. The standard fee for a camp term is $1,000. The physician’s salary for this part-time work would be $1,000. How should White Pine Camp account for this arrangement?

c. Lightning during a storm damaged the camp dining hall. The cost to repair the damage will be $5,400 over and above what the insurance company will pay.

Ethical Issues

Ethical Issue 1

The following excerpt was taken from the Chief Executive Officer’s message to the shareholders in the Nortel Networks Corporation 2004 Annual Report:

This was a challenging year for your company. Early in 2004, after concerns were raised regarding the integrity of previously reported financial results, new management examined these statements in depth. That examination led to the restatement of the years ended 2001, 2002, the revision of previously announced results for the year ended 2003, and the restatement of the first three quarters of 2003, which have all now been filed. The company has now completed its financial statements for 2004.

Required

1. Why is it important that this type of information be disclosed?

2. Suppose you are the chief financial officer (CFO) responsible for the financial statements of Nortel. What ethical issues would you face as you consider what to report in the Nortel 2004 Annual Report?

3. What are the negative consequences to Nortel of not telling the truth? What are the negative consequences to Nortel of telling the truth?
Ethical Issue 2

The board of directors of Cloutier Inc. is meeting to discuss the past year’s results before releasing financial statements to the public. The discussion includes this exchange:

Sue Cloutier, company president: “Well, this has not been a good year! Revenue is down and expenses are up—way up. If we don’t do some fancy stepping, we’ll report a loss for the third year in a row. I can temporarily transfer some land that I own into the company’s name, and that will beef up our balance sheet. Rob, can you shave $500,000 from expenses? Then we can probably get the bank loan that we need.”

Rob Samuels, company chief accountant: “Sue, you are asking too much. Generally accepted accounting principles are designed to keep this sort of thing from happening.”

Required
1. What is the fundamental ethical issue in this situation?
2. Discuss how Sue Cloutier’s proposals violate generally accepted accounting principles. Identify the specific concept(s) or principle(s) involved.

Problems (Group A)

Problem 1–1A

Gail Bradley was a civil engineer and partner in a large firm, a partnership, for five years after graduating from university. Recently she resigned her position to open her own consultancy practice, which she operates as a proprietorship. The name of the new company is Bradley Consultants.

Bradley recorded the following events during the organizing phase of her new business and its first month of operations. Some of the events were personal and did not affect the consultancy practice. Others were business transactions and should be accounted for by the business.

July 4 Bradley received $60,000 cash from her former partners in the firm from which she resigned.
5 Bradley invested $10,500 cash in her business, Bradley Consultants.
5 The business paid office rent expense for the month of July, $1,800.
6 The business paid $450 cash for letterhead stationery for the office.
7 The business purchased office furniture for the office and will pay the account payable, $3,000, within six months.
10 Bradley sold 750 shares of Dofasco stock, which she had owned for several years, receiving $27,000 cash from her stockbroker.
11 Bradley deposited the $27,000 cash from sale of the Dofasco stock in her personal bank account.
12 A representative of a large construction company telephoned Bradley and told her of the company’s intention to transfer its consulting business to Bradley Consultants.
29 The business finished an assessment for a client and submitted the bill for services, $7,500. The business expected to collect from this client within two weeks.
31 Bradley withdrew $1,500 cash from the business.

Required
1. Classify each of the preceding events as one of the following (list each date, then choose a, b, or c):
   a. A business transaction to be accounted for by the business, Bradley Consultants.
   b. A business-related event but not a transaction to be accounted for by Bradley Consultants.
   c. A personal transaction not to be accounted for by Bradley Consultants.
2. Analyze the effects of the above events on the accounting equation of Bradley Consultants. Use a format similar to Exhibit 1–9, Panel B, on page 19.
**Problem 1–2A**

Paul Keeler is a realtor. He buys and sells properties on his own, and he also earns commission revenue as a real estate agent. He organized his business as a sole proprietorship on November 24, 2007. Consider the following facts as of November 30, 2007:

a. Keeler owed $16,500 on a note payable for some undeveloped land. This land had been acquired by the business for a total price of $30,000.

b. Keeler’s business had spent $7,500 for a Re/Max Ltd. real estate franchise, which entitled him to represent himself as a Re/Max agent. Re/Max is a national affiliation of independent real estate agents. This franchise is a business asset.

c. Keeler owed $240,000 on a personal mortgage on his personal residence, which he acquired in 2001 for a total price of $510,000.

d. Keeler had $30,000 in his personal bank account and $5,100 in his business bank account.

e. Keeler owed $1,800 on a personal charge account with The Bay.

f. The business acquired business furniture for $5,100 on November 25. Of this amount, the company owed $1,800 on account at November 30.

g. The real estate office had $300 worth of office supplies on hand on November 30.

**Required**


2. Identify the personal items given in the preceding facts that would not be reported on the balance sheet of the business.

**Problem 1–3A**

Port Hardey Suppliers was recently formed. The balance of each item in the business’s accounting equation is shown below for June 21 and for each of the nine following business days.

<table>
<thead>
<tr>
<th>Accounts</th>
<th>Cash</th>
<th>Accounts Payable</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supplies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance expense</td>
<td></td>
<td>$2,000</td>
<td>$25,500</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Note payable</td>
<td></td>
<td></td>
<td>125,000</td>
</tr>
<tr>
<td>Rent expense</td>
<td></td>
<td></td>
<td>23,000</td>
</tr>
<tr>
<td>Salary expense</td>
<td></td>
<td></td>
<td>120,000</td>
</tr>
<tr>
<td>Salary payable</td>
<td></td>
<td></td>
<td>9,000</td>
</tr>
<tr>
<td>Service revenue</td>
<td></td>
<td></td>
<td>255,000</td>
</tr>
<tr>
<td>Supplies</td>
<td></td>
<td></td>
<td>3,000</td>
</tr>
<tr>
<td>Building</td>
<td></td>
<td></td>
<td>170,000</td>
</tr>
<tr>
<td>Consultant expense</td>
<td></td>
<td></td>
<td>18,000</td>
</tr>
<tr>
<td>Electronic equipment</td>
<td></td>
<td></td>
<td>110,000</td>
</tr>
<tr>
<td>Furniture</td>
<td></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Total assets</td>
<td></td>
<td></td>
<td>335,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td></td>
<td></td>
<td>125,000</td>
</tr>
<tr>
<td>Total equity</td>
<td></td>
<td></td>
<td>210,000</td>
</tr>
</tbody>
</table>

**Required**

Assuming that a single transaction took place on each day, describe briefly the transaction that was most likely to have occurred. Begin with June 22 and complete up to June 30. Indicate which accounts were affected and by what amount. No revenue or expense transactions occurred on these dates.

**Problem 1–4A**

Presented below are the amounts of (a) the assets and liabilities of Premium Sounds as of December 31, 2008, and (b) the revenues and expenses of the company for the year ended December 31, 2008. The items are listed in alphabetical order.

**Balance sheet for a sole proprietorship, entity concept**

1. Total assets $48,000

**Excel Spreadsheet Template**

**Income statement, statement of owner’s equity, balance sheet**

1. Net income $70,000
2. S. Chai, capital, Dec. 31, 2008 $165,000
3. Total assets $335,000
The opening balance of owner’s equity was $150,000. At year end, after the calculation of net income, the owner, Shiraz Chai, withdrew $55,000.

**Required**

1. Prepare the business’s income statement for the year ended December 31, 2008.
2. Prepare the statement of owner’s equity of the business for the year ended December 31, 2008.
4. Answer these questions about the business:
   a. Was the result of operations for the year a profit or a loss? How much was it?
   b. Did the business’s owner’s equity increase or decrease during the year? How would this affect the business’s ability to borrow money from a bank in the future?
   c. How much in total economic resources does the business have at December 31, 2008, as it moves into the new year? How much does the business owe? What is the dollar amount of the owner’s portion of the business at December 31, 2008?

**Problem 1–5A**

The bookkeeper of Kirkham Services Co., a proprietorship, prepared the balance sheet of the company while the accountant was ill. The balance sheet is not correct. The bookkeeper knew that the balance sheet should balance, so he plugged in the owner’s equity amount needed to achieve this balance. The owner’s equity amount, however, is not correct. All other amounts are accurate.

**KIRKHAM SERVICES CO.**

**Balance Sheet**

**For the Month Ended July 31, 2007**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash...........................</td>
<td>Service revenue................</td>
</tr>
<tr>
<td>Office supplies ...............</td>
<td>$44,000</td>
</tr>
<tr>
<td>Land............................</td>
<td>$144,000</td>
</tr>
<tr>
<td>Advertising expense ..........</td>
<td>Note payable...................</td>
</tr>
<tr>
<td>Office furniture .............</td>
<td>$2,000</td>
</tr>
<tr>
<td>Accounts receivable ..........</td>
<td>Note payable...................</td>
</tr>
<tr>
<td>Rent expense..................</td>
<td>$88,000</td>
</tr>
<tr>
<td></td>
<td>Accounts payable...............</td>
</tr>
<tr>
<td></td>
<td>$5,000</td>
</tr>
<tr>
<td></td>
<td>Total liabilities and</td>
</tr>
<tr>
<td>Total assets...................</td>
<td>owner’s equity................</td>
</tr>
<tr>
<td></td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>J. Kirkham, capital...........</td>
</tr>
<tr>
<td></td>
<td>$88,000</td>
</tr>
<tr>
<td></td>
<td>29,000</td>
</tr>
<tr>
<td></td>
<td>Total liabilities and</td>
</tr>
<tr>
<td></td>
<td>owner’s equity................</td>
</tr>
<tr>
<td></td>
<td>$241,000</td>
</tr>
</tbody>
</table>

**Required**

1. Prepare the correct balance sheet, and date it correctly. Compute total assets, total liabilities, and owner’s equity.
2. Identify the accounts listed above that should not be presented on the balance sheet and state why you excluded them from the correct balance sheet you prepared for Requirement 1.

**Problem 1–6A**

Phyllis Fauburn is the proprietor of a career counselling and employee search business, Fauburn Personnel Services. The following amounts summarize the financial position of the business on August 31, 2007:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash + Accounts + Supplies +</td>
<td>Furniture and Computers +</td>
</tr>
<tr>
<td>P. Fauburn, Capital</td>
<td>Accounts Payable + P. Fauburn,</td>
</tr>
<tr>
<td>Bal. 15,000</td>
<td>16,000</td>
</tr>
<tr>
<td></td>
<td>48,000</td>
</tr>
<tr>
<td></td>
<td>26,000</td>
</tr>
</tbody>
</table>

During September 2007, the following company transactions occurred:

a. Phyllis Fauburn deposited $80,000 cash in the business bank account.

b. Performed services for a client and received cash of $3,600.
d. Purchased supplies on account, $4,000.
e. Collected cash from a customer on account, $4,000.
f. Consulted on a large downsizing by a major corporation and billed the client for services rendered, $32,000.
g. Recorded the following business expenses for the month:
   (1) Paid office rent for September 2007—$3,600.
   (2) Paid advertising—$400.
h. Sold supplies to another business for $600 cash, which was the cost of the supplies.
i. Phyllis Fauburn withdrew $16,000 cash.

Required

1. Analyze the effects of the above transactions on the accounting equation of Fauburn Personnel Services. Adapt the format of Exhibit 1–9, Panel B on page 19.

Problem 1–7A

Michael Chung had been operating his law practice in Mississauga under the name Michael Chung, Lawyer, for two years and had the following business assets and liabilities (at their historical costs) on April 30, 2007:

<table>
<thead>
<tr>
<th>Asset/Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>4,500</td>
</tr>
<tr>
<td>Supplies</td>
<td>600</td>
</tr>
<tr>
<td>Furniture and computers</td>
<td>21,000</td>
</tr>
</tbody>
</table>

The following business transactions took place during the month of May 2007:

May  1 Chung deposited $30,000 cash into the business bank account.
    3 Chung completed legal work for a home builder. He charged the builder $1,500, not the $2,700 the work was worth, in order to promote business from the builder.
    5 The business bought furniture from Arthur Frame for $6,000, paying $1,500 cash and promising to pay $750 a month at the beginning of each month starting June 1, 2007, for six months. Chung would like to expense the entire amount to reduce net income for tax reasons.
    10 The company signed a lease to rent additional space at a cost of $1,350 per month. Michael Chung will occupy the premises effective June 1, 2007.
    18 Determining that the business would need more cash in June, Chung went to the bank and borrowed $1,500 on a personal loan and transferred the money to the company.
    25 Chung purchased a painting for his home from one of his clients. He paid for the $450 purchase with his personal credit card.
    28 Chung withdrew $4,500 from the business. He used $1,500 of the money to repay a portion of the loan arranged on May 18.
    31 The business did legal work with a value of $6,000 for Apex Computers Ltd. Apex paid for the work by giving the company computer equipment with a selling price of $12,000.

Required

Identify the accounting characteristic, assumption, or principle that would be applicable to each of the transactions and discuss the effects it would have on the financial statements of Michael Chung, Lawyer.
Problem 1–8A

Herley City was started on December 31, 2007, by Jason Elliott with an investment of $30,000 cash. It has been operating for one year. Elliott has made additional investments of $20,000 but he has not withdrawn any funds. The company rents out snowboards and related gear from a small store. The balance sheet accounts at November 30, 2008, are as follows:

- Cash ............................................. $ 2,000
- Accounts receivable ..................... 18,000
- Rental gear ................................. 36,000
- Rental snowboards ................... 68,000
- Store equipment........................ 26,000
- Accounts payable ..................... 24,000

The following transactions took place during the month of December 2008:

Dec. 1 Elliott borrowed $30,000 from his family and invested $24,000 in the business. The other $6,000 was intended for Elliott’s living expenses.
1 The business paid $6,000 for the month’s rent on the store space.
4 The business signed a one-year lease for the rental of additional store space at a cost of $4,000 per month. The lease is effective January 1. The business will pay the first month’s rent in January.
6 Rental fees for the week were: Gear, $12,000; Boards, $28,000. Half the fees were paid in cash and half on account.
10 The business paid the accounts payable from November 30, 2008.
12 The business purchased gear for $18,000 and boards for $32,000, all on account.
13 Rental fees for the week were: Gear, $6,000; Boards, $12,000. All the fees were paid in cash.
15 The company received payment for the accounts receivable owing at November 30, 2008.
18 The company purchased store equipment for $8,000 by paying $2,000 cash with the balance due in 60 days.
20 Rental fees for the week were: Gear, $8,000; Boards, $20,000. Half the fees were paid in cash and half on account.
24 The company paid the balance owing for the purchases made on December 12.
27 Rental fees for the week were: Gear, $4,000; Boards, $16,000. All the fees were paid in cash.
27 The company received payment for rental fees on account from December 6.

Required

1. What is the total net income earned by the business over the period of December 31, 2007 to November 30, 2008?
3. Prepare the income statement for Herley City for the month ended December 31, 2008.
4. Prepare the statement of owner’s equity for Herley City for the month ended December 31, 2008.
5. Prepare the balance sheet for Herley City at December 31, 2008.
6. Elliott has expressed concern that although the business seems to be profitable and growing, he constantly seems to be investing additional money into it and has been unable to make any withdrawals for the work he has put into it. Prepare a reply to his concerns.

Problems (Group B)

Problem 1–1B

Sam Shipley is an architect and was a partner with a large firm, a partnership, for 10 years after graduating from university. Recently he resigned his position to open his own architecture office, which he operates as a proprietorship. The name of the new entity is Shipley Design.
Shipley recorded the following events during the organizing phase of his new business and its first month of operations. Some of the events were personal and did not affect the practice of architecture. Others were business transactions and should be accounted for by the business.

July 1 Sam Shipley sold 2,000 shares of Royal Bank stock, which he had owned for several years, receiving $11,000 cash from his stockbroker.
2 Sam Shipley deposited the $11,000 cash from sale of the Royal Bank stock in his personal bank account.
3 Sam Shipley received $30,000 cash from his former partners in the architecture firm from which he resigned.
5 Sam Shipley deposited $20,000 into a bank account in the name of Shipley Design.
5 Shipley Design paid office rent for the month of July, $1,380.
6 A representative of a large real estate company telephoned Sam Shipley and told him of the company’s intention to transfer its design business to his business, Shipley Design.
7 Shipley Design paid $110 cash for letterhead stationery.
9 Shipley Design purchased office furniture for the office, on account, for $1,900, promising to pay in three months.
23 Shipley Design finished design work for a client and submitted the bill for design services, $2,600. It expects to collect from this client within one month.
31 Sam Shipley withdrew $1,200 for personal use.

Required

1. Classify each of the preceding events as one of the following (list each date and then choose a, b, or c):
   a. A business transaction to be accounted for by the business, Shipley Design.
   b. A business-related event but not a transaction to be accounted for by Shipley Design.
   c. A personal transaction not to be accounted for by Shipley Design.

2. Analyze the effects of the above events on the accounting equation of Shipley Design. Use a format similar to Exhibit 1–9, Panel B, on page 19.

Problem 1–2B

Luella Hyde is a realtor. She buys and sells properties on her own, and she also earns commission revenue as a real estate agent. She invested $60,000 on March 10, 2007, in the business, Luella Hyde Realty. Consider the following facts as of March 31, 2007:

a. Hyde had $15,000 in her personal bank account and $74,000 in the business bank account.

b. The real estate office had $11,500 of office supplies on hand on March 31, 2007.

c. Luella Hyde Realty had spent $22,500 for a Realty World Canada franchise, which entitled the company to represent itself as a Realty World Canada member firm. This franchise is a business asset.

d. The company owed $105,500 on a note payable for some undeveloped land that had been acquired by the company for a total price of $116,000.

e. Hyde owed $165,000 on a personal mortgage on her personal residence, which she acquired in 2001 for a total price of $360,000.

f. Hyde owed $1,500 on a personal charge account with The Bay.

g. The company acquired business furniture for $41,000 on March 26. Of this amount, Luella Hyde Realty owed $32,000 on account at March 31, 2007.

Required

2. Identify the personal items given in the preceding facts that would not be reported on the balance sheet of the business.

Problem 1–3B

Recently, Carole Gallagher formed a management accounting practice as a proprietorship. The balance of each item in the proprietorship accounting equation follows for November 2 and for each of the eight following business days.
Part 1
The Basic Structure of Accounting

Excel Spreadsheet Template

Required

Assuming that a single transaction took place on each day, describe briefly the transaction that was most likely to have occurred. Begin with November 9 and complete up to November 30. Indicate which accounts were affected and by what amount. No revenue or expense transactions occurred on these dates.

Problem 1–4B

The amounts of (a) the assets and liabilities of Jiffey Office Cleaning as of December 31, 2007, and (b) the revenues and expenses of the company for the year ended on December 31, 2007, appear below. The items are listed in alphabetical order.

Required

4. Answer these questions about Jiffey Office Cleaning.
   a. Was the result of operations for the year a profit or a loss? How much was it?
   b. Did the business’s owner’s equity increase or decrease during the year? How would this affect the business’s ability to borrow money from a bank in the future?
   c. How much in total economic resources does the company have at December 31, 2007, as it moves into the new year? How much does the company owe? What is the dollar amount of the owner’s portion of the business at December 31, 2007?

Problem 1–5B

The bookkeeper of Shamanski Insurance Agency prepared the balance sheet of the company while the accountant was ill. The balance sheet contains errors. In particular, the bookkeeper knew that the balance sheet should balance, so she “plugged in” the owner’s equity amount needed to achieve this balance. The owner’s equity amount, however, is not correct. All other amounts are accurate.
Required

1. Prepare the correct balance sheet, and date it correctly. Compute total assets, total liabilities, and owner’s equity.

2. Identify the accounts listed above that should not be presented on the balance sheet and state why you excluded them from the correct balance sheet you prepared for Requirement 1.

Problem 1–6B

Terry Thibert operates an interior design studio called Thibert Design Studio. The following amounts summarize the financial position of the business on April 30, 2007:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>Accounts Payable</td>
<td>T. Thibert, Capital</td>
</tr>
<tr>
<td>Supplies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal. 13,440</td>
<td>14,480</td>
<td>48,200</td>
</tr>
</tbody>
</table>

During May 2007 the company did the following:

a. Thibert received $28,000 as a gift and deposited the cash in the business bank account.

b. Paid the beginning balance of accounts payable.

c. Performed services for a client and received cash of $2,200.

d. Collected cash from a customer on account, $1,800.

e. Purchased supplies on account, $1,440.

f. Consulted on the interior design of a major office building and billed the client for services rendered, $12,000.

g. Recorded the following business expenses for the month:
   (1) Paid office rent for May 2007—$2,400.
   (2) Paid advertising—$1,320.

h. Sold supplies to another interior designer for $160 cash, which was the cost of the supplies.

i. Terry Thibert withdrew $2,800 cash for personal use.

Required

1. Analyze the effects of the above transactions on the accounting equation of Thibert Design Studio. Adapt the format of Exhibit 1–9, Panel B, on page 19.


Problem 1–7B

Jesse Burgess has been operating a plumbing business as a proprietorship (Jesse Burgess Plumbing) for four years and had the following business assets and liabilities (at their historical costs) on May 31, 2007:

- Cash: $30,000
- Accounts receivable: $15,000
- Shop supplies: $6,000
- Shop equipment: $45,000
- Accounts payable: $15,000

The following events took place during the month of June 2007:

June 1 Jesse’s brother, John, had been in a similar business in the same city and moved to England. He sold Jesse his equipment for $27,000. The equipment had cost $51,000 and had a replacement cost of $33,000.

3 The business did some plumbing repairs for Sheldon Kantor, a customer. The business would normally have charged $600 for the work, but had agreed to do it for $450 cash in order to promote more business from the client.

10 The business signed a lease to rent additional shop space for the business at a cost of $2,400 per month. The business will occupy the premises effective July 1, 2007.

18 Finding he was low on cash, Jesse Burgess went to the bank and borrowed $4,500 on a personal loan.

22 Inflation has caused the value of the shop equipment to double to $90,000. Jesse does not understand why accountants ignore the effect of inflation in the accounting records.

28 Jesse Burgess withdrew $6,000 from the business and used $4,500 to repay the personal bank loan of June 18.

Required Identify the accounting assumption, principle, or constraint that would be applicable to each of the events, and discuss the effects it would have on the financial statements of Jesse Burgess Plumbing.

Problem 1–8B

Select Computer Concepts, a proprietorship owned by Melanie Rindt, was started on January 1, 2005, by Melanie Rindt with an investment of $20,000 cash. It has been operating for three years. Rindt has made additional investments of $44,000 but has not made any withdrawals. The company prepares marketing plans for clients and has seen business grow from a small business using rented equipment and having only a few customers to one with the following balances as of December 31, 2007:

- Cash: $8,000
- Accounts receivable: $16,000
- Software: $12,000
- Office furniture: $48,000
- Computer equipment: $72,000
- Accounts payable: $26,000
- Owner’s equity: $130,000

The following transactions took place during the month of January 2008:

Jan. 2 Rindt invested $30,000 in the business.

2 The business paid $4,000 for the month’s rent on the office space.

4 The business signed a lease for the rental of additional office space at a cost of $2,000 per month. The lease is effective February 1. The business will pay the first month’s rent in February.

6 The business developed a systems design for Fleming Ltd. and received $18,000 now plus additional $10,000 payments to be received on the 15th of the month for the next three months.

10 The business paid $1,000 to a courier service.

12 Rindt signed an agreement to provide design work to Smith Inc. for $50,000 to be paid upon completion of the work.

14 The company purchased $10,000 of software that will be required for the Smith assignment. The company paid $6,000 and promised to pay the balance by the end of the month.
Jan. 15 The company received $10,000 as the monthly payment from Fleming Ltd. of January 6.
18 The company purchased computer equipment for $40,000 by paying $8,000 cash with the balance due in 60 days.
23 The company completed a network design for Wong Ltd., which promised to pay $15,000 by the end of the month.
29 The company paid the balance owing for the software purchased on January 14.

Required
1. What is the total net income earned by the business over the period of January 1, 2005, to December 31, 2007?
6. Rindt has expressed concern that although the business seems to be profitable and growing, she constantly seems to be investing additional money into it and has been unable to make any withdrawals for the work she has put into it. Prepare a reply to her concerns.

Challenge Problems

Problem 1–1C
The going-concern assumption is becoming an increasing source of concern for users of financial statements. There are instances of companies filing for bankruptcy several months after issuing their annual audited financial statements. The question is: why didn’t the financial statements predict the problem?
A friend has just arrived on your doorstep; you realize she is very angry. After calming her down, you ask what the problem is. She tells you that she had inherited $25,000 from an uncle and invested the money in the common shares of Always Good Yogurt Corp. She had carefully examined Always Good Yogurt’s financial statements for the year ended six months previously and concluded that the company was financially sound. This morning, she had read in the local paper that the company had gone bankrupt and her investment was worthless. She asks you why the financial statements valued the assets at values that are in excess of those the Trustee in Bankruptcy expects to realize from liquidating the assets. Why have the assets suddenly lost so much of the value they had six months ago?

Required Explain to your friend why assets are valued on a going-concern basis in the financial statements and why they are usually worth less when the company goes out of business. Use inventory and accounts receivable as examples.

Problem 1–2C
You and three friends have decided to go into the lawn care business for the summer to earn money to pay for your schooling in the fall. Your first step was to sign up customers to satisfy yourselves that the business had the potential to be profitable. Next, you planned to go to the bank to borrow money to buy the equipment you would need.
After considerable effort, your group obtained contracts from customers for 200 lawns for the summer. One of your partners wants to prepare a balance sheet showing the value of the contracts as an asset. She is sure that you will have no trouble with borrowing the necessary funds from the bank on the basis of the proposed balance sheet.

Required Explain to your friend why the commitments (signed contracts) from customers cannot be recognized as assets. What suggestions do you have that might assist your group in borrowing the necessary funds?
Decision Problems

Decision Problem 1

Two businesses, Tyler’s Bicycle Centre and Ryan’s Catering, have sought business loans from you. To decide whether to make the loans, you have requested their balance sheets.

TYLER’S BICYCLE CENTRE
Balance Sheet
December 31, 2007

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable ..................</td>
</tr>
<tr>
<td>13,500</td>
<td>18,000</td>
</tr>
<tr>
<td>Accounts receivable ..........</td>
<td>Notes payable .....................</td>
</tr>
<tr>
<td>21,000</td>
<td>177,000</td>
</tr>
<tr>
<td>Merchandise inventory ........</td>
<td>Total liabilities ................</td>
</tr>
<tr>
<td>127,500</td>
<td>195,000</td>
</tr>
<tr>
<td>Store supplies ..............</td>
<td></td>
</tr>
<tr>
<td>750</td>
<td></td>
</tr>
<tr>
<td>Furniture and fixtures ......</td>
<td>Owner’s Equity</td>
</tr>
<tr>
<td>13,500</td>
<td></td>
</tr>
<tr>
<td>Building ....................</td>
<td>T. Jones, capital ................</td>
</tr>
<tr>
<td>123,000</td>
<td>125,250</td>
</tr>
<tr>
<td>Land</td>
<td>Total liabilities and owner’s equity</td>
</tr>
<tr>
<td>21,000</td>
<td></td>
</tr>
<tr>
<td>Total assets ................</td>
<td></td>
</tr>
<tr>
<td>$320,250</td>
<td></td>
</tr>
</tbody>
</table>

RYAN’S CATERING
Balance Sheet
December 31, 2007

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable ..................</td>
</tr>
<tr>
<td>15,000</td>
<td>4,500</td>
</tr>
<tr>
<td>Accounts receivable ..........</td>
<td>Note payable .....................</td>
</tr>
<tr>
<td>6,000</td>
<td>102,000</td>
</tr>
<tr>
<td>Office supplies .............</td>
<td>Total liabilities ................</td>
</tr>
<tr>
<td>3,000</td>
<td>106,500</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
</tr>
<tr>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Office furniture ............</td>
<td>Owner’s Equity</td>
</tr>
<tr>
<td>7,500</td>
<td></td>
</tr>
<tr>
<td>Investments* ...............</td>
<td>R. Smith, capital ................</td>
</tr>
<tr>
<td>300,000</td>
<td>255,000</td>
</tr>
<tr>
<td>Total assets ...............</td>
<td>Total liabilities and owner’s equity</td>
</tr>
<tr>
<td>$361,500</td>
<td></td>
</tr>
</tbody>
</table>

*The investments of $300,000 can be sold today for $380,000.

Required

1. Based solely on these balance sheets, which entity would you be more comfortable loaning money to? Explain fully, citing specific items and amounts from the balance sheets.
2. In addition to the balance sheet data, what other financial statement information would you require? Be specific.

Decision Problem 2

A friend learns that you are taking an accounting course. Knowing that you do not plan a career in accounting, the friend asks why you are “wasting your time.” Explain to the friend:

1. Why you are taking the course.
2. How accounting information is used or will be used:
   a. In your personal life.
   b. In the business life of your friend, who plans to be a farmer.
   c. In the business life of another friend, who plans a career in sales.
Financial Statement Cases

These and similar problems in later chapters focus on the financial statements of two real Canadian companies—CHUM Limited and Sun-Rype Products Ltd. CHUM Limited is one of Canada’s leading media companies and content providers, which owns and operates 33 radio stations, 12 local television stations, and 21 specialty channels, as well as an environmental music distribution division. (On August 31, 2006, Bell Globemia Inc. was successful in its offer to acquire CHUM Limited. As a result, Bell Globemia will de-list CHUM Limited’s common shares and Class B Shares on the Toronto Stock Exchange.) Sun-Rype Products Ltd. is a leading manufacturer and marketer of juice-based beverages and fruit-based snacks located in the fruit-growing district of British Columbia but with sales across Canada. As you study each financial statement problem using these two companies, you will gradually build the confidence that you can understand and use actual financial statements.

Financial Statement Case 1

Refer to the CHUM Limited financial statements located in Appendix A at the end of this book. Notice that the amounts reported in CHUM’s financial statements are in thousands of dollars.

Required

1. How much cash and short-term deposits did CHUM Limited have at August 31, 2005?
2. What were total assets at August 31, 2005? At August 31, 2004?
3. Write the company’s accounting equation at August 31, 2005, by filling in the dollar amounts:
   
   \[ \text{ASSETS} = \text{ LIABILITIES + SHAREHOLDERS’ EQUITY} \]

4. Identify total revenue for the year ended August 31, 2005. Do the same for the year ended August 31, 2004. Did revenue increase or decrease in fiscal 2005?
5. How much net income or net loss did CHUM Limited experience for the year ended August 31, 2005? Was 2005 a good year or bad year compared to 2004?

Financial Statement Case 2

Refer to the Sun-Rype Products Ltd. financial statements located in Appendix B at the end of this book. Notice that the amounts reported in Sun-Rype’s financial statements are in thousands of dollars.

Required

1. During 2006, Sun-Rype announced a special dividend declaration. Use the Internet to summarize the details of the March 3, 2006, press release and your interpretation of this announcement. Sun-Rype’s website is accessible at www.sun-rype.com; you can also find financial information and press releases at www.sedar.com.
2. How much cash and cash equivalents did Sun-Rype have at December 31, 2005?
3. What were total assets at December 31, 2005? At December 31, 2004?
4. Write the company’s accounting equation at December 31, 2005, by filling in the dollar amounts:
   
   \[ \text{ASSETS} = \text{ LIABILITIES + SHAREHOLDERS’ EQUITY} \]

5. Identify total sales revenue for the year ended December 31, 2005, and the year ended December 31, 2004. Did revenue increase or decrease during 2005?
6. How much net income or net loss did Sun-Rype experience for the year ended December 31, 2005? Was 2005 a good year or bad year compared to 2004?