

ESSENTIALS OF Accounting

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Essentials of **ACCOUNTING**

9th Edition

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Preface

PURPOSE

Our objective in revising the ninth edition of *Essentials of Accounting* was to make a good text even better. To that end, we have made many changes with the student in mind. Coverage has been condensed in order to present concepts in the most straightforward way possible. All problems and solutions have been double-verified. Our goal is for students to *understand* and *enjoy* reading the material rather than be unnecessarily confused by complicated grammar and vocabulary. The ninth edition continues to take a hands-on approach to teaching accounting. Students take from the course a basic understanding of accounting procedures and the ability to perform basic accounting tasks with confidence.

AUDIENCE

Essentials of Accounting was written to be used in a one-term or one-semester introductory accounting course. Coverage of the entire text will provide the student with a solid understanding of accounting for an office business. Specifically, we focus on professional service businesses that are not involved with inventories of goods for resale or for use in manufacturing products for resale. Chapters 7 and 8 of the text offer an in-depth look at accounting in the legal and medical office environments—they are mini-practice sets that offer hands-on experience.

ORGANIZATION

In the ninth edition, we have organized the text in a more logical progression of concepts. Chapter 1 has been rewritten to include the expanded accounting equation. New tables show different revenue account titles and expense account titles for various types of service businesses. The first four chapters now present the accounting cycle, beginning with analyzing source documents, recording journal entries, and posting. Sample transactions are presented and traced through the accounting records so that students can see how information flows through the cycle. We conclude by presenting the end-of-period adjustments, the work sheet, closing entries, and the financial statements.

In Chapter 5, we turn to cash accounting—receipts and payments, use of a change fund, use of the petty cash fund, and banking procedures. Students learn how to reconcile a bank account and record the journal entries that accompany it. In Chapter 6, we explain payroll and the taxes, tax forms, and journal entries that accompany it.

Chapters 7 and 8 are unique in that they offer students the opportunity to use all of the information they have been building on in the earlier chapters. In Chapter 7, students follow along as the accounting cycle for Wilson Simmons, Attorney at Law, is completed. In Chapter 8, students observe the accounting cycle for Cole and Martin, Physicians and Surgeons. These two demonstration problems give students a hands-on look at the accounting procedures required in these two office environments.

GENERAL FEATURES

In the ninth edition, not only have we made the text more accessible by dividing chapters into modules, but the end-of-chapter materials are now more accessible as well because we have used a logical numbering system. Each of these learning units begins with a list of learning objectives and presents a concise, easy-to-read body of information. Each module concludes with a set of concept questions so students can check their comprehension before going forward.

“Key Point” headers continue throughout the text. Typically, the headers indicate pivotal material that can lead to confusion later if forgotten. Students are alerted by this header to pay close attention.

Throughout the text, we use color to highlight numbers in illustrated transactions, journals, and financial statements. As they read, students can see at a glance what number is being discussed in the text.

At the end of each chapter, we present Exercises, A and B Series Problems, and a Challenge Problem. Students working through an A Series Problem in class can try the B Series Problem on their own at home. These problems are intentionally similar in order to offer an opportunity for additional practice. Challenge Problems encourage students to apply all of the information they have learned in the chapter.

New to this edition are two comprehensive review problems, located after Chapters 2 and 4. These problems are designed to cover the whole accounting cycle.

A full glossary at the end of the book contains all key terms and their definitions, together with other words that are used often or that may be confusing or difficult to remember.

A Check Figures Appendix at the end of the text provides quick solutions to many of the problems. Students can check to see if they have arrived at the correct solution and, if not, set out to discover their error.

ANCILLARIES

The following ancillaries are available with the ninth edition of *Essentials*.

For the instructor:

Instructor's Resource Guide. More than a solutions manual, the Instructor's Resource Guide is a complete teaching resource. This item includes chapter summaries, teaching transparency masters that can be used as overheads or notes for the chalkboard, chapter outlines that are keyed to the teaching transparencies, teaching suggestions, and answers to the Concept Questions, Exercises, and Problems.

Test Bank and Achievement Tests. The test bank for this edition contains over 500 true-false and multiple-choice questions and problems. A computerized version of the test bank is also available.

Included in the printed test bank are achievement tests that correspond to each chapter in the text. These tests are perforated for easy removal and photocopying. Each test includes both matching questions and problems.

For the student:

Study Guide and Working Papers. For this edition of *Essentials*, the Study Guide contains a variety of learning aids, in addition to the working papers needed for the end-of-chapter exercises and problems. For each chapter, we have included a variety of review questions (true-false, multiple-choice, and fill-in-the-blank). In addition, each chapter includes at least one demonstration problem. Students work through the problem and then check the solution for immediate feedback.

General Ledger Software. With this edition the General Ledger Software has been expanded, and problems have been added from Chapters 2 through 6 as well as for Chapters 7 and 8. It has been carefully prepared to offer the beginning accounting student a thorough, but basic, introduction to computerized accounting. For a more thorough introduction to computerized accounting, students re-visit the narrative of transactions for Wilson Simmons, Attorney at Law, and Cole and Martin, Physicians and Surgeons. In these versions, however, the narratives have been re-written to include step-by-step instructions for using the data disk. Students can continue to practice their automated accounting skills by solving the problems that follow each narrative—again, following the step-by-step instructions.

Practice Sets. Two practice sets are available with *Essentials of Accounting*. Both practice sets are designed to give students a review of the complete accounting cycle and require approximately 12 to 15 hours to complete.

Norma Staples, Attorney at Law, covers the transactions for the last month of the fiscal year in the office of an attorney. It contains special journals, office dockets, collection dockets, and other auxiliary records unique to an attorney. This practice set reviews the entire accounting cycle, including the preparation of the financial statements. It is designed for use following Chapter 7.

James Collier and Karen Wray, Physicians and Surgeons, provides practice in recording the transactions for the last month in the fiscal year in a physician's office. It contains special journals, a daily service record, a patient ledger, and other auxiliary records unique to a medical practice. This practice set reviews the entire accounting cycle, including the preparation of the financial statements. It is designed for use upon completion of Chapter 8.

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Chapter ONE

The Nature of Accounting

The following modules will be covered in this chapter:

Module 1A

The Accounting Equation and Financial Statements

Understanding the basic Accounting Equation and preparing a basic set of financial statements.

Module 1B

The Double-Entry System of Accounting

Applying the double-entry system of accounting using T accounts.

The Accounting Equation and Financial Statements

Module 1A Objectives

Careful study of this module should enable you to:

1. Understand the process of accounting.
2. Show the effects of selected business transactions on the accounting equation.
3. Prepare a simple income statement, a statement of owner's equity, and a balance sheet.

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

THE ACCOUNTING PROCESS

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

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

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

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

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

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

Interpreting the reported results is the final phase of the process. At this time, attention is directed to the significance of various matters and relationships. Percentage analyses and ratios often are used to help explain the difference among accounting periods. Footnotes and special captions also may be valuable in the interpreting phase of accounting.

Accounting and Bookkeeping

An accountant is a professional with the education and experience to design an accounting system, prepare reports, and interpret their results. A person who solely records accounting information is referred to as a **bookkeeper**.

Accounting Elements

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

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

Assets. An item of value that is owned and will provide future benefits is called an **asset**. Such items include cash, office supplies, office equipment and land. Another type of asset is an account receivable. This is an unwritten promise by a customer to pay for services rendered.

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

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

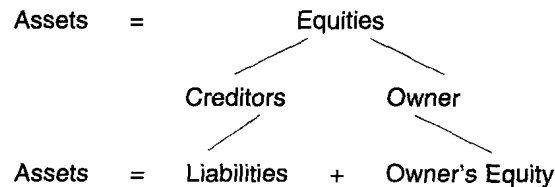
Owner's Equity. The amount by which business assets exceed business liabilities is called **owner's equity**. If there are no liabilities, the

owner's equity is equal to the total amount of the assets. Owner's equity is increased with revenue, and decreased by expenses or an owner's withdrawal.

A business that is owned by one person is a proprietorship. The owner of the business is known as the proprietor.

The Accounting Equation

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



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

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

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

The effect of any transaction on the accounting equation may be indicated by increasing or decreasing a specific asset, liability or owner's equity element. To illustrate, assume the following transactions took place during January, 200X, for Dick Ady, Dentist. The effect of these transactions on the accounting equation can be analyzed as follows:

Transaction (a): Owner invested \$30,000 cash in the business.

Effect on Accounting Equation. An increase in an asset offset by an increase in owner's equity

Analysis. Ady opened a bank account for his business with a deposit of \$30,000. This transaction increased the asset Cash. Since Ady contributed the asset, owner's equity—Dick Ady, Capital—was increased by the same amount. The equation for the business would appear as follows:

Assets		=	Liabilities	+	Owner's Equity
Cash		=			Dick Ady, Capital
(a)	+30,000				+30,000
Total Assets: \$30,000 = Total Liabilities + Owner's Equity: \$30,000					

Transaction (b): Purchased office equipment on account, \$2,500.

Effect on Accounting Equation. An increase in an asset offset by an increase in a liability

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

Assets		=	Liabilities	+	Owner's Equity
Cash	+ Office Equipment	=	Accounts Payable	+	Dick Ady, Capital
Bal. \$30,000					\$30,000
(b)	+2,500		+2,500		
Bal. \$30,000	+ \$2,500	=	\$2,500	+	\$30,000
Total Assets: \$32,500 = Total Liabilities + Owner's Equity: \$32,500					

Transaction (c): Purchased office supplies for cash, \$350.

Effect on Accounting Equation. An increase in one asset offset by a decrease in another asset

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

Assets				=	Liabilities	+	Owner's Equity	
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	+	Dick Ady, Capital
Bal. \$30,000				\$2,500		\$2,500		\$30,000
(c) <u>- 350</u>		<u>+350</u>						
Bal. \$29,650	+	\$350	+	\$2,500	=	\$2,500	+	\$30,000
Total Assets: \$32,500 = Total Liabilities + Owner's Equity: \$32,500								

Transaction (d): Paid amount owed to a creditor, \$500.

Effect on Accounting Equation. A decrease in an asset offset by a decrease in a liability

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

Assets				=	Liabilities	+	Owner's Equity	
Cash	+	Office Supp.	+	Office Equip.	=	Accounts Payable	+	Dick Ady, Capital
Bal. \$29,650		\$350		\$2,500		\$2,500		\$30,000
(d) <u>- 500</u>						<u>- 500</u>		
Bal. \$29,150	+	\$350	+	\$2,500	=	\$2,000	+	\$30,000
Total Assets: \$32,000 = Total Liabilities + Owner's Equity: \$32,000								

Transaction (e): Purchased office supplies on account, \$400.

Effect on Accounting Equation. An increase in an asset offset by an increase in a liability

Analysis. Ady purchased office supplies on account for \$400. This transaction caused the asset Office Supplies to increase by \$400 and increased the liability Accounts Payable by the same amount. The effect of this transaction on the equation is as follows: