Financial Accounting with Ready Notes

University of Maine

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Chapters were selected from the following texts:

FINANCIAL ACCOUNTING A Business Perspective, Sixth Edition, by Roger H. Hermanson, Ph.D., CPA and James Don Edwards, Ph.D., CPA.

Ready Notes for use with FINANCIAL ACCOUNTING A Business Perspective by Jon A. Booker, Charles W. Caldwell, Susan Galbreath, and Richard S. Rand.

FINANCIAL ACCOUNTING WITH READY NOTES

4 5 6 7 8 9 QD 0 9 0 9

ISBN 0-256-26699-9

Editor: Karen Perry
Printer/Binder: Quebecor

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ACCOUNTING AND ITS USE IN BUSINESS DECISIONS

The Introduction to this text provided a background for your study of accounting. Now you are ready to learn about the forms of business organizations and the types of business activities they perform. This chapter presents the financial statements used by businesses. These financial statements show the results of decisions made by management. Creditors, investors, and managers use these statements in evaluating management's past decisions and as a basis for making future decisions.

In this chapter, you also study the accounting process (or accounting cycle) that accountants use to prepare those financial statements. This accounting process uses financial data such as the records of sales made to customers and purchases made from suppliers. In a systematic manner, accountants analyze, record, classify, summarize, and finally report these data in the financial statements of businesses. As you study this chapter, you will begin to understand the unique, systematic nature of accounting—the language of business.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Identify and describe the three basic forms of business organizations.
2. Distinguish among the three types of activities performed by business organizations.
3. Describe the content and purposes of the income statement, statement of retained earnings, balance sheet, and statement of cash flows.
4. State the basic accounting equation and describe its relationship to the balance sheet.

(continued)

FORMS OF BUSINESS ORGANIZATIONS

Accountants frequently refer to a business organization as an *accounting entity* or a *business entity*. A business entity is any business organization, such as a hardware store or grocery store, that exists as an economic unit. For accounting purposes, each business organization or **entity** has an existence separate from its owner(s), creditors, employees, customers, and other businesses.[1] This separate existence of the business organization is known as the **business entity concept**

[1] When first studying any discipline, students encounter new terms. Usually these terms are set in boldface color and defined at their first occurrence. The boldface color terms are also listed and defined at the end of each chapter (see pages 35–36 in this chapter). After the definition of the term in the term list, a page number in parentheses indicates where the term is discussed in the chapter.

(concluded)

5. Using the underlying assumptions or concepts, analyze business transactions and determine their effects on items in the financial statements.
6. Prepare an income statement, a statement of retained earnings, and a balance sheet.
7. Analyze and use the financial results—the equity ratio.

Thus, in the accounting records of the business entity, the activities of each business should be kept separate from the activities of other businesses and from the personal financial activities of the owner(s).

Assume, for example, that you own two businesses, a physical fitness center and a horse stable. According to the business entity concept, you would consider each business as an independent business unit. Thus, you would normally keep separate accounting records for each business. Now assume your physical fitness center is unprofitable because you are not charging enough for the use of your exercise equipment. You can determine this fact because you are treating your physical fitness center and horse stable as two separate business entities. You must also keep your personal financial activities separate from your two businesses. Therefore, you cannot include the car you drive only for personal use as a business activity of your physical fitness center or your horse stable. However, the use of your truck to pick up feed for your horse stable is a business activity of your horse stable.

As you will see shortly, the business entity concept applies to the three forms of businesses—single proprietorships, partnerships, and corporations. Thus, for accounting purposes, all three business forms are separate from other business entities and from their owner(s). Although corporations are also legally separate from their owners, this is not true for single proprietorships and partnerships. We use the corporate approach in this text and include only a brief discussion of single proprietorships and partnerships.

Single Proprietorship

Objective 1
Identify and describe the three basic forms of business organizations.[2]

A **single proprietorship** is an unincorporated business owned by an individual and often managed by that same person. Single proprietors include physicians, lawyers, electricians, and other people in business for themselves. Many small service businesses and retail establishments are also single proprietorships. No legal formalities are necessary to organize such businesses, and usually business operations can begin with only a limited investment.

In a single proprietorship, the owner is solely responsible for all debts of the business. For accounting purposes, however, the business is a separate entity from the owner. Thus, single proprietors must keep the financial activities of the business, such as the receipt of fees from selling services to the public, separate from their personal financial activities. For example, owners of single proprietorships should not enter the cost of personal houses or car payments in the financial records of their businesses.

Partnership

A **partnership** is an unincorporated business owned by two or more persons associated as partners. Often the same persons who own the business also manage the business. Many small retail establishments and professional practices, such as dentists, physicians, attorneys, and many CPA firms, are partnerships.

A partnership begins with a verbal or written agreement. A written agreement is preferable because it provides a permanent record of the terms of the partnership. These terms include the initial investment of each partner, the duties of each partner, the means of dividing profits or losses between the partners each year, and the settlement after the death or withdrawal of a partner. Each partner may be held liable for all the debts of the partnership and for the actions of each partner within the scope of the business. However, as with the single proprietorship, for accounting purposes, the partnership is a separate business entity.

[2] After reading a portion of text material that covers a certain learning objective, some students immediately want to work an exercise that illustrates that material. The exercises at the end of each chapter are labeled with the learning objective to which they pertain. For instance, turn to pages 37–39 to see which learning objective(s) each exercise covers in Chapter 1.

Corporation

A **corporation** is a business incorporated under the laws of a state and owned by a few stockholders or thousands of stockholders. Almost all large businesses and many small businesses are incorporated.

The corporation is unique in that it is a separate legal business entity. The owners of the corporation are **stockholders or shareholders.** They buy shares of stock, which are units of ownership, in the corporation. Should the corporation fail, the owners would only lose the amount they paid for their stock. The corporate form of business protects the personal assets of the owners from the creditors of the corporation.[3]

Stockholders do not directly manage the corporation. They elect a board of directors to represent their interests. The board of directors selects the officers of the corporation, such as the president and vice presidents, who manage the corporation for the stockholders.

Accounting is necessary for all three forms of business organizations, and each company must follow generally accepted accounting principles (GAAP). Since corporations have such an important impact on our economy, we use them in this text to illustrate basic accounting principles and concepts.

An Accounting Perspective

Business Insight Although corporations constitute about 17% of all business organizations, they account for almost 90% of all sales volume. Single proprietorships constitute about 75% of all business organizations but account for less than 10% of sales volume.

Types of Activities Performed by Business Organizations

Objective 2
Distinguish among the three types of activities performed by business organizations.

The forms of business entities discussed in the previous section are classified according to the type of ownership of the business entity. Business entities can also be grouped by the type of business activities they perform—service companies, merchandising companies, and manufacturing companies. Any of these activities can be performed by companies using any of the three forms of business organizations.

1. **Service companies** perform services for a fee. This group includes accounting firms, law firms, and dry cleaning establishments. The early chapters of this text describe accounting for service companies.
2. **Merchandising companies** purchase goods that are ready for sale and then sell them to customers. Merchandising companies include auto dealerships, clothing stores, and supermarkets. We begin the description of accounting for merchandising companies in Chapter 6.
3. **Manufacturing companies** buy materials, convert them into products, and then sell the products to other companies or to the final consumers. Manufacturing companies include steel mills, auto manufacturers, and clothing manufacturers. We begin our coverage of manufacturing accounting in Chapter 18.

All of these companies produce financial statements as the final end product of their accounting process. These financial statements provide relevant financial information both to those inside the company—management—and to those outside the company—creditors, stockholders, and other interested parties. The next section introduces four common financial statements—the income statement, the statement of retained earnings, the balance sheet, and the statement of cash flows.

[3] When individuals seek a bank loan to finance the formation of a small corporation, the bank often requires those individuals to sign documents making them personally responsible for repaying the loan if the corporation cannot pay. In this instance, the individuals can lose their original investments plus the amount of the loan they are obligated to repay.

Financial Statements of Business Organizations

Objective 3
Describe the content and purposes of the income statement, statement of retained earnings, balance sheet, and statement of cash flows.

Business entities may have many objectives and goals. For example, one of your objectives in owning a physical fitness center may be to improve *your* physical fitness. However, the two primary objectives of every business are profitability and solvency. **Profitability** is the ability to generate income. **Solvency** is the ability to pay debts as they become due. Unless a business can produce satisfactory income and pay its debts as they become due, the business cannot survive to realize its other objectives.

The financial statement that reflects a company's profitability is the **income statement.** The **statement of retained earnings** shows the change in retained earnings between the beginning and end of a period (e.g., a month or a year). The **balance sheet** reflects a company's solvency. The **statement of cash flows** shows the cash inflows and outflows for a company over a period of time. The headings and elements of each statement are similar from company to company. You have probably noticed this similarity in the financial statements of actual companies in the annual report booklet.

The Income Statement

The **income statement,** sometimes called an earnings statement, reports the profitability of a business organization for a *stated period of time*. In accounting, we measure profitability for a period, such as a month or year, by comparing the revenues generated with the expenses incurred to produce these revenues. **Revenues** are the inflows of assets (such as cash) resulting from the sale of products or the rendering of services to customers. We measure revenues by the prices agreed on in the exchanges in which a business delivers goods or renders services. **Expenses** are the costs incurred to produce revenues. Expenses are measured by the assets surrendered or consumed in serving customers. If the revenues of a period exceed the expenses of the same period, **net income** results. Thus,

$$\text{Net income} = \text{Revenues} - \text{Expenses}$$

Net income is often called the *earnings* of the company. When expenses exceed revenues, the business has a **net loss,** and it has operated unprofitably.

In Illustration 1.1, Part A shows the income statement of Metro Courier, Inc., for July 1997. This California corporation performs courier delivery services of documents and packages in San Diego.

Metro's income statement for the month ended July 31, 1997, shows that the revenues (or delivery fees) generated by serving customers for July totaled $5,700. Expenses for the month amounted to $3,600. As a result of these business activities, Metro's net income for July was $2,100. To determine its net income, the company subtracts its expenses of $3,600 from its revenues of $5,700. Even though corporations are taxable entities, we ignore corporate income taxes at this point.

The Statement of Retained Earnings

One purpose of the *statement of retained earnings* is to connect the income statement and the balance sheet. The **statement of retained earnings** explains the changes in retained earnings between two balance sheet dates. These changes usually consist of the addition of net income (or deduction of net loss) and the deduction of dividends.

Dividends are the means by which a corporation rewards its stockholders (owners) for providing it with investment funds. A **dividend** is a payment (usually of cash) to the owners of the business; it is a distribution of income to owners rather than an expense of doing business. Because dividends are not an expense, they do not appear on the income statement.

The effect of a dividend is to reduce cash and retained earnings by the amount paid out. Then, the company no longer retains a portion of the income earnings but passes it on to the stockholders. Earning dividends is, of course, one of the primary reasons people invest in corporations.

ILLUSTRATION 1.1

A. Income Statement

METRO COURIER, INC.
Income Statement
For the Month Ended July 31, 1997

Revenues:		
Service revenue		$5,700
Expenses:		
Salaries expense	$2,600	
Rent expense	400	
Gas and oil expense	600	
Total expenses		3,600
Net income		$2,100

B. Statement of Retained Earnings

METRO COURIER, INC.
Statement of Retained Earnings
For the Month Ended July 31, 1997

Retained earnings, July 1	$-0-
Add: Net income for July	2,100
Retained earnings, July 31	$2,100

C. Balance Sheet

METRO COURIER, INC.
Balance Sheet
July 31, 1997

Assets		**Liabilities and Stockholders' Equity***	
Cash	$15,500	Liabilities:	
Accounts receivable	700	Accounts payable	$ 600
Trucks	20,000	Notes payable	6,000
Office equipment	2,500	Total liabilities	$ 6,600
		Stockholders' equity:	
		Capital stock	$30,000
		Retained earnings	2,100
		Total stockholders' equity	$32,100
Total assets	$38,700	Total liabilities and stockholders' equity	$38,700

* The liabilities and stockholders' equity portion of the balance sheet may be shown directly beneath the assets instead of to the right of them, as shown here. When liabilities and stockholders' equity are placed under the assets, the balance sheet is in the *vertical format* or *report form*. The vertical format is as acceptable as the *horizontal format* (or account form) used above.

The statement of retained earnings for Metro Courier, Inc., for July 1997 is relatively simple (see Part B of Illustration 1.1). Organized on June 1, Metro did not earn any revenues or incur any expenses during June. So Metro's beginning retained earnings balance on July 1 is zero. Metro then adds its $2,100 net income for July. Since Metro paid no dividends in July, the $2,100 would be the ending balance.

Next, Metro carries this $2,100 ending balance in retained earnings to the balance sheet (Part C). If there had been a net loss, it would have deducted the loss from the beginning balance on the statement of retained earnings. For instance, if during the next month (August) there is a net loss of $500, the loss would be deducted from the beginning balance in retained earnings of $2,100. The retained earnings balance at the end of August would be $1,600.

Dividends could also have affected the Retained Earnings balance. To give a more realistic illustration, assume that (1) Metro Courier, Inc.'s net income for August was actually $1,500 (revenues of $5,600 less expenses of $4,100) and (2) the company declared and paid dividends of $1,000. Then, Metro's statement of retained earnings for August would be:

METRO COURIER, INC.
Statement of Retained Earnings
For the Month Ended August 31, 1997

Retained earnings, August 1	$2,100
Add: Net income for August	1,500
Total	$3,600
Less: Dividends	1,000
Retained earnings, August 31	$2,600

The Balance Sheet

The **balance sheet,** sometimes called the *statement of financial position,* lists the company's assets, liabilities, and stockholders' equity (including dollar amounts) as of a specific moment in time. That specific moment is the close of business on the date of the balance sheet. Notice how the heading of the balance sheet differs from the headings on the income statement and statement of retained earnings. A balance sheet is like a photograph; it captures the financial position of a company at a particular *point* in time. The other two statements are for a *period* of time. As you study about the assets, liabilities, and stockholders' equity contained in a balance sheet, you will understand why this financial statement provides information about the solvency of the business.

Assets are things of value owned by the business. They are also called the *resources* of the business. Examples include cash, machines, and buildings. Assets have value because a business can use or exchange them to produce the services or products of the business. In Part C of Illustration 1.1, the assets of Metro Courier, Inc., amount to $38,700. Metro's assets consist of cash, **accounts receivable** (amounts due from customers for services previously rendered), trucks, and office equipment.

Liabilities are the debts owed by a business. Typically, a business must pay its debts by certain dates. A business incurs many of its liabilities by purchasing items on credit. Metro's liabilities consist of **accounts payable** (amounts owed to suppliers for previous purchases) and **notes payable** (written promises to pay a specific sum of money) totaling $6,600.[4]

Metro Courier, Inc., is a corporation. The owners' interest in a corporation is referred to as **stockholders' equity.** Metro's stockholders' equity consists of (1) $30,000 paid for shares of capital stock and (2) retained earnings of $2,100. **Capital stock** shows the amount of the owners' investment in the corporation. **Retained earnings** generally consists of the accumulated net income of the corporation minus dividends distributed to stockholders. We discuss these items later in the text. At this point, simply note that the balance sheet heading includes the name of the organization and the title and date of the statement. Notice also that the dollar amount of the total assets is equal to the claims on (or interest in) those assets. The balance sheet shows these claims under the heading "Liabilities and Stockholders' Equity."

The Statement of Cash Flows

Management is interested in the cash inflows to the company and the cash outflows from the company because these determine the company's liquidity—its ability to pay its bills when due. The **statement of cash flows** shows the cash inflows and cash outflows from operating, investing, and financing activities. *Operating activities* generally include the cash effects of transactions and other events that enter into the determination of net income. *Investing activities* gener-

[4] Most notes bear interest, but in this chapter we assume that all notes bear no interest. Interest is an amount paid by the borrower to the lender (in addition to the amount of the loan) for use of the money over time.

ally include business transactions involving the acquisition or disposal of long-term assets such as land, buildings, and equipment. *Financing activities* generally include the cash effects of transactions and other events involving creditors and owners (stockholders).

Chapter 16 describes the statement of cash flows in detail. Our purpose here is to merely introduce this important financial statement. Normally, a firm prepares a statement of cash flows for the same time period as the income statement. The following statement, however, shows the cash inflows and outflows for Metro Courier, Inc., since it was formed on June 1, 1997. Thus, this cash flow statement is for two months.

METRO COURIER, INC.
Statement of Cash Flows
For the Two-Month Period Ended July 31, 1997

Cash flows from operating activities:		
Net income	$ 2,100	
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	(700)	
Increase in accounts payable	600	
Net cash provided by operating activities		$ 2,000
Cash flows from investing activities:		
Purchase of trucks	$(20,000)	
Purchase of office equipment	(2,500)	
Net cash used by investing activities		(22,500)
Cash flows from financing activities:		
Proceeds from notes payable	$ 6,000	
Proceeds from sale of capital stock	30,000	
Net cash provided by financing activities		36,000
Net increase in cash		$ 15,500

At this point in the course, you need to understand what a statement of cash flows is rather than how to prepare it. We do not ask you to prepare such a statement until you have studied Chapter 16.

The income statement, statement of retained earnings, balance sheet, and the statement of cash flows of Metro Courier, Inc., are the result of management's past decisions. They are the end products of the accounting process, which we explain in the next section. These financial statements give a picture of the solvency and profitability of the company. The accounting process details how this picture was made. Management and other interested parties use these statements to make future decisions. Management is the first to know the financial results; then, it publishes the financial statements to inform other users.

The Financial Accounting Process

In this section, we explain the accounting equation—the framework for the entire accounting process. Then, we show you how to recognize a business transaction and describe underlying assumptions that accountants use to record business transactions. Next, you learn how to analyze and record business transactions.

The Accounting Equation

Objective 4
State the basic accounting equation and describe its relationship to the balance sheet.

In the balance sheet presented in Illustration 1.1 (Part C), the total assets of Metro Courier, Inc., were equal to its total liabilities and stockholders' equity. This equality shows that the assets of a business are equal to its equities; that is,

$$\text{Assets} = \text{Equities}$$

Assets were defined earlier as the things of value owned by the business, or the economic resources of the business. **Equities** are all claims to, or interests in, assets. For example, assume that you purchased a new company automobile for

$15,000 by investing $10,000 in your own corporation and borrowing $5,000 in the name of the corporation from a bank. Your equity in the automobile is $10,000, and the bank's equity is $5,000. You can further describe the $5,000 as a liability because the corporation owes the bank $5,000. Also, you can describe your $10,000 equity as stockholders' equity or interest in the asset. Since the owners in a corporation are stockholders, the basic **accounting equation** becomes:

$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Stockholders' Equity (SE)}$$

From Metro's balance sheet in Illustration 1.1 (Part C), we can enter in the amount of its assets, liabilities, and stockholders' equity:

$$\begin{array}{ccccc} A & = & L & + & SE \\ \$38{,}700 & = & \$6{,}600 & + & \$32{,}100 \end{array}$$

Remember that someone must provide assets or resources—either a creditor or a stockholder. Therefore, this equation must always be in balance.

You can also look at the right side of this equation in another manner. The liabilities and stockholders' equity show the sources of an existing group of assets. Thus, liabilities are not only claims against assets but also sources of assets.

Either creditors or owners provide all the assets in a corporation. The higher the proportion of assets provided by owners, the more solvent the company. However, companies can sometimes improve their profitability by borrowing from creditors and using the funds effectively. As a business engages in economic activity, the dollar amounts and composition of its assets, liabilities, and stockholders' equity change. *However, the equality of the basic accounting equation always holds.*

Analysis of Transactions

Objective 5
Using the underlying assumptions or concepts, analyze business transactions and determine their effects on items in the financial statements.

An accounting **transaction** is a business activity or event that causes a measurable change in the accounting equation, Assets = Liabilities + Stockholders' Equity. An exchange of cash for merchandise is a transaction. The exchange takes place at an agreed price that provides an objective measure of economic activity. For example, the objective measure of the exchange may be $5,000. These two factors—evidence and measurement—make possible the recording of a transaction. Merely placing an order for goods is not a recordable transaction because no exchange has taken place.

A *source document* usually supports the evidence of the transaction. A **source document** is any written or printed evidence of a business transaction that describes the essential facts of that transaction. Examples of source documents are receipts for cash paid or received, checks written or received, bills sent to customers for services performed or bills received from suppliers for items purchased, cash register tapes, sales tickets, and notes given or received. We handle source documents constantly in our everyday life. Each source document initiates the process of recording a transaction.

Underlying Assumptions or Concepts In recording business transactions, accountants rely on certain underlying assumptions or concepts. Both preparers and users of financial statements must understand these assumptions:

1. **Business entity concept** (or accounting entity concept). Data gathered in an accounting system relate to a specific business unit or **entity.** The business entity concept assumes that each business has an existence separate from its owners, creditors, employees, customers, other interested parties, and other businesses.
2. **Money measurement concept.** Economic activity is initially recorded and reported in a common monetary unit of measure—the dollar in the United States. This form of measurement is known as *money measurement.*
3. **Exchange-price (or cost) concept (principle).** Most of the amounts in an accounting system are the objective money prices determined in the ex-

change process. As a result, we record most assets at their acquisition cost. **Cost** is the sacrifice made or the resources given up, measured in money terms, to acquire some desired thing, such as a new truck (asset).

4. **Going-concern (continuity) concept.** Unless strong evidence exists to the contrary, accountants assume that the business entity will continue operations into the indefinite future. Accountants call this assumption the *going-concern or continuity* concept. Assuming that the entity will continue indefinitely allows accountants to value long-term assets, such as land, at cost on the balance sheet since they are to be used rather than sold. Market values of these assets would be relevant only if they were for sale. For instance, accountants would still record land purchased in 1988 at its cost of $100,000 on the December 31, 1997, balance sheet even though its market value has risen to $300,000.
5. **Periodicity (time periods) concept.** According to the *periodicity (time periods)* concept or assumption, an entity's life can be meaningfully subdivided into time periods (such as months or years) to report the results of its economic activities.

Now that you understand business transactions and the five basic accounting assumptions, you are ready to follow some business transactions step by step. To begin, we divide Metro's transactions into two groups: (1) transactions affecting only the balance sheet in June, and (2) transactions affecting the income statement and/or the balance sheet in July. Note that we could also classify these transactions as operating, investing, or financing activities, as shown in the statement of cash flows on page 21.

Transactions Affecting Only the Balance Sheet Since each transaction affecting a business entity must be recorded in the accounting records, analyzing a transaction before actually recording it is an important part of financial accounting. An error in transaction analysis results in incorrect financial statements.

To illustrate the analysis of transactions and their effects on the basic accounting equation, the activities of Metro Courier, Inc., that led to the statements in Illustration 1.1 follow. The first set of transactions (for June), 1a, 2a, and so on, are repeated in the summary of transactions, Illustration 1.2 (Part A) on page 25. The second set of transactions (for July) (1b–6b) are repeated in Illustration 1.3 (Part A) on page 29.

1a. Owners Invested Cash When Metro Courier, Inc., was organized as a corporation on June 1, 1997, the company issued shares of capital stock for $30,000 cash to Ron Chaney, his wife, and their son. This transaction increased assets (cash) of Metro by $30,000 and increased equities (the capital stock element of stockholders' equity) by $30,000. Consequently, the transaction yields the following basic accounting equation:

		Assets				=	Liabilities		+	Stockholders' Equity
Trans-action	Explanation	Cash	Accounts Receiv-able	Trucks	Office Equip-ment		Accounts Payable	Notes Payable		Capital Stock
	Beginning balances	$ -0-	$ -0-	$ -0-	$ -0-	=	$ -0-	$ -0-	+	$ -0-
1a	Stockholders invested cash	+30,000								+30,000
	Balances after transaction	$30,000				=				$30,000
		Increased by $30,000								*Increased by $30,000*

2a. Borrowed Money The company borrowed $6,000 from Chaney's father. Chaney signed the note for the company. The note bore no interest and the company promised to repay (recorded as a *note payable*) the amount borrowed within one year. After including the effects of this transaction, the basic equation is:

		Assets				=	Liabilities		+	Stockholders' Equity
Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock
	Balances before transaction	$30,000				=				$30,000
2a	Borrowed money	+6,000						+6,000		
	Balances after transaction	$36,000				=		$6,000	+	$30,000
		Increased by $6,000						*Increased by $6,000*		

3a. Purchased Trucks and Office Equipment for Cash Metro paid $2,000 cash for two used delivery trucks and $1,000 for office equipment. Trucks and office equipment are assets because the company uses them to earn revenues in the future. Note that this transaction does not change the total amount of assets in the basic equation but only changes the composition of the assets. This transaction decreased cash and increased trucks and office equipment (assets) by the total amount of the cash decrease. Metro received two assets and gave up one asset of equal value. Total assets are still $36,000. The accounting equation now is:

		Assets				=	Liabilities		+	Stockholders' Equity
Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock
	Balances before transaction	$36,000				=		$6,000	+	$30,000
3a	Purchased equipment for cash	−21,500		+20,000	+1,500					
	Balances after transaction	$14,500		$20,000	$1,500	=		$6,000	+	$30,000
		Decreased by $21,500		*Increased by $20,000*	*Increased by $1,500*					

4a. Purchased Office Equipment on Account (for Credit) Metro purchased an additional $1,000 of office equipment on account, agreeing to pay within 10 days after receiving the bill. (To purchase an item *on account* means to buy it on credit.) This transaction increased assets (office equipment) and liabilities (accounts payable) by $1,000. As stated earlier, accounts payable are amounts owed to suppliers for items purchased on credit. Now you can see the $1,000 increase in the assets and liabilities as follows:

		Assets				=	Liabilities		+	Stockholders' Equity
Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock
	Balances before transaction	$14,500		$20,000	$1,500	=		$6,000	+	$30,000
4a	Purchased office equipment on account				+1,000		+1,000			
	Balances after transaction	$14,500		$20,000	$2,500	=	$1,000	$6,000	+	$30,000
					Increased by $1,000		*Increased by $1,000*			

5a. Paid an Account Payable Eight days after receiving the bill, Metro paid $1,000 for the office equipment purchased on account (transaction 4a). This trans-

ILLUSTRATION 1.2

A. Summary of Transactions

METRO COURIER, INC.
Summary of Transactions
Month of June 1997

		Assets				=	Liabilities		+	Stockholders' Equity
Transaction	**Explanation**	**Cash**	**Accounts Receivable**	**Trucks**	**Office Equipment**		**Accounts Payable**	**Notes Payable**		**Capital Stock**
	Beginning balances	$ -0-	$ -0-	$ -0-	$ -0-	=	$ -0-	$ -0-		$ -0-
1a	Stockholders invested cash	+30,000								+30,000
		$30,000				=				$30,000
2a	Borrowed money	+6,000						+6,000		
		$36,000				=		$6,000	+	$30,000
3a	Purchased trucks and office equipment for cash	−21,500		+20,000	+1,500					
		$14,500		$20,000	$1,500	=		$6,000	+	$30,000
4a	Purchased office equipment on account				+1,000		+1,000			
		$14,500		$20,000	$2,500	=	$1,000	$6,000	+	$30,000
5a	Paid an account payable	−1,000					−1,000			
	End-of-month balances	$13,500	$ -0-	$20,000	$2,500	=	$ -0-	$6,000	+	$30,000

B. Balance Sheet

METRO COURIER, INC.
Balance Sheet
June 30, 1997

Assets		**Liabilities and Stockholders' Equity**		
Cash	$13,500	Liabilities:		
Trucks	20,000	Notes payable	$6,000	
Office Equipment	2,500	Total liabilities		$ 6,000
		Stockholders' equity:		
		Capital Stock		30,000
Total assets	$36,000	Total liabilities and stockholders' equity		$36,000

action reduced cash by $1,000 and reduced accounts payable by $1,000. Thus, the assets and liabilities both are reduced by $1,000, and the equation again balances as follows:

		Assets				=	Liabilities		+	Stockholders' Equity
Transaction	**Explanation**	**Cash**	**Accounts Receivable**	**Trucks**	**Office Equipment**		**Accounts Payable**	**Notes Payable**		**Capital Stock**
	Balances before transaction	$14,500		$20,000	$2,500	=	$1,000	$6,000	+	$30,000
5a	Paid an account payable	−1,000					−1,000			
	End-of-month balances	$13,500	$ -0-	$20,000	$2,500	=	$ -0-	$6,000	+	$30,000
		Decreased by $1,000					*Decreased by $1,000*			

Illustration 1.2, Part A, is a *summary of transactions* prepared in accounting equation form for June. A **summary of transactions** is a teaching tool used to show the effects of transactions on the accounting equation. Note that the stockholders' equity has remained at $30,000. This amount changes as the business begins to earn revenues or incur expenses. You can see how the totals at the bottom of Part A of Illustration 1.2 tie into the balance sheet shown in Part B. The date on the balance sheet is June 30, 1997. These totals become the beginning balances for July 1997.

Thus far, all transactions have consisted of exchanges or acquisitions of assets either by borrowing or by owner investment. We used this procedure to help you focus on the accounting equation as it relates to the balance sheet. However, people do not form a business only to hold present assets. They form businesses so their assets can generate greater amounts of assets. Thus, a business increases its assets by providing goods or services to customers. The results of these activities appear in the income statement. The section that follows shows more of Metro's transactions as it began earning revenues and incurring expenses.

Transactions Affecting the Income Statement and/or Balance Sheet To survive, a business must be profitable. This means that the revenues earned by providing goods and services to customers must exceed the expenses incurred.

In July 1997, Metro Courier, Inc., began selling services and incurring expenses. The explanations of transactions that follow allow you to participate in this process and learn the necessary accounting procedures.

1b. Earned Service Revenue and Received Cash As its first transaction in July, Metro performed delivery services for customers and received $4,800 cash. This transaction increased an asset (cash) by $4,800. Stockholders' equity (retained earnings) also increased by $4,800, and the accounting equation was in balance.

The $4,800 is a revenue earned by the business and, as such, increases stockholders' equity (in the form of retained earnings) because stockholders prosper when the business earns profits. Likewise, the stockholders would sustain any losses, which would reduce retained earnings.

Revenues increase the amount of retained earnings and expenses and dividends decrease them. (In this first chapter, we show all of these items as immediately affecting retained earnings. In later chapters, the revenues, expenses, and dividends are accounted for separately from retained earnings during the accounting period and are transferred to retained earnings only at the end of the accounting period as part of the "closing process" described in Chapter 4.) The effects of this $4,800 transaction on the financial status of Metro are:

		Assets				=	Liabilities		+	Stockholders' Equity	
Transaction	**Explanation**	**Cash**	**Accounts Receivable**	**Trucks**	**Office Equipment**		**Accounts Payable**	**Notes Payable**		**Capital Stock**	**Retained Earnings**
	Beginning balances (Illustration 1.2)	$13,500	$ -0-	$20,000	$2,500	=	$ -0-	$6,000	+	$30,000	$ -0-
1b	Earned service revenue and received cash	+4,800									+4,800 (service revenue)
	Balances after transaction	$18,300		$20,000	$2,500	=		$6,000	+	$30,000	$4,800
		Increased by $4,800									*Increased by $4,800*

Metro would record the increase in stockholders' equity brought about by the revenue transaction as a separate item, "Retained earnings." This does not increase capital stock because the Capital Stock account increases only when the company issues shares of stock. The expectation is that revenue transactions will exceed expenses and yield net income. If net income is not distributed to stockholders, it is in fact retained. Later chapters show that because of complexities in handling large numbers of transactions, revenues and expenses affect retained earnings only at the end of an accounting period. The preceding procedure is a shortcut used to explain why the accounting equation remains in balance.

2b. Service Revenue Earned on Account (for Credit) Metro performed courier delivery services for a customer who agreed to pay $900 at a later date. The company granted credit rather than requiring the customer to pay cash immediately. This is called earning revenue *on account*. The transaction consists of exchanging services for the customer's promise to pay later. This transaction is similar to the preceding transaction in that stockholders' equity (retained earnings) increases because the company has earned revenues. However, the transaction differs because the company has not received cash. Instead, the company has received another asset, an *account receivable*. As noted earlier, an account receivable is the amount due from a customer for goods or services already provided. The company has a legal right to collect from the customer in the future. Accounting recognizes such claims as assets. The accounting equation, including this $900 item, is as follows:

		Assets				=	Liabilities		+	Stockholders' Equity	
Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock	Retained Earnings
	Balances before transaction	$18,300		$20,000	$2,500	=		$6,000	+	$30,000	$4,800
2b	Earned service revenue on account		+900								+900 (service revenue)
	Balances after transaction	$18,300	$900	$20,000	$2,500	=		$6,000	+	$30,000	$5,700
			Increased by $900								*Increased by $900*

3b. Collected Cash on Accounts Receivable Metro collected $200 on account from the customer in transaction 2b. The customer will pay the remaining $700 later. This transaction affects only the balance sheet and consists of giving up a claim on a customer in exchange for cash. The transaction increases cash by $200 and decreases accounts receivable by $200. Note that this transaction consists solely of a change in the composition of the assets. When the company performed the services, it recorded the revenue. Therefore, the company does not record the revenue again when collecting the cash.

		Assets				=	Liabilities		+	Stockholders' Equity	
Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock	Retained Earnings
	Balances before transaction	$18,300	$900	$20,000	$2,500	=		$6,000	+	$30,000	$5,700
3b	Collected cash on account	+200	−200								
	Balances after transaction	$18,500	$700	$20,000	$2,500	=		$6,000	+	$30,000	$5,700
		Increased by $200	*Decreased by $200*								

4b. Paid Salaries Metro paid employees $2,600 in salaries. This transaction is an exchange of cash for employee services. Typically, companies pay employees for their services after they perform their work. Salaries (or wages) are costs companies incur to produce revenues, and companies consider them an expense. Thus, the accountant treats the transaction as a decrease in an asset (cash) and a decrease in stockholders' equity (retained earnings) because the company has incurred an expense. Expense transactions reduce net income. Since net income becomes a part of the retained earnings balance, expense transactions reduce the retained earnings.

Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock	Retained Earnings
		Assets				=	Liabilities		+	Stockholders' Equity	
	Balances before transaction . . .	$18,500	$700	$20,000	$2,500	=		$6,000	+	$30,000	$5,700
4b	Paid salaries. . . .	−2,600									−2,600 (salaries expense)
	Balances after transaction . . .	$15,900	$700	$20,000	$2,500	=		$6,000	+	$30,000	$3,100
		Decreased by $2,600									*Decreased by $2,600*

5b. Paid Rent In July, Metro paid $400 cash for office space rental. This transaction causes a decrease in cash of $400 and a decrease in retained earnings of $400 because of the incurrence of rent expense.

Transaction 5b has the following effects on the amounts in the accounting equation:

Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock	Retained Earnings
		Assets				=	Liabilities		+	Stockholders' Equity	
	Balances before transaction. . . .	$15,900	$700	$20,000	$2,500	=		$6,000	+	$30,000	$3,100
5b	Paid rent	−400									−400 (rent expense)
	Balances after transaction. . . .	$15,500	$700	$20,000	$2,500	=		$6,000	+	$30,000	$2,700
		Decreased by $400									*Decreased by $400*

6b. Received Bill for Gas and Oil Used At the end of the month, Metro received a $600 bill for gas and oil consumed during the month. This transaction involves an increase in accounts payable (a liability) because Metro has not yet paid the bill and a decrease in retained earnings because Metro has incurred an expense. Metro's accounting equation now reads:

Transaction	Explanation	Cash	Accounts Receivable	Trucks	Office Equipment		Accounts Payable	Notes Payable		Capital Stock	Retained Earnings
		Assets				=	Liabilities		+	Stockholders' Equity	
	Balances before transaction . . .	$15,500	$700	$20,000	$2,500	=		$6,000	+	$30,000	$2,700
6b	Received bill for gas and oil used . . .						+600				−600 (gas and oil expense)
	End-of-month balances	$15,500	$700	$20,000	$2,500	=	$600	$6,000	+	$30,000	$2,100
							Increased by $600				*Decreased by $600*