

ACCOUNTING PRINCIPLES



THE NAVIGATOR ✓

- Understand *Concepts for Review*

- Read *Feature Story*

- Scan *Study Objectives*

- Read *Preview*

- Read text and answer *Before You Go On*
p. 36 p. 43 p. 51 p. 55
p. 57

- Work *Demonstration Problems*

- Review *Summary of Study Objectives*

- Complete *Assignments*

CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

- a. The two organizations primarily responsible for setting accounting standards. (Ch. 1, pp. 8–9)
- b. The monetary unit assumption and the economic entity assumption. (Ch. 1, pp. 9–10)
- c. The cost principle. (Ch. 1, p. 9)

F E A T U R E S T O R Y

Certainly Worth Investigating!

It is often difficult to determine in what period some revenues and expenses should be reported. There are rules that give guidance; but occasionally, these rules are overlooked, misinterpreted, or even intentionally ignored. Consider the following examples.

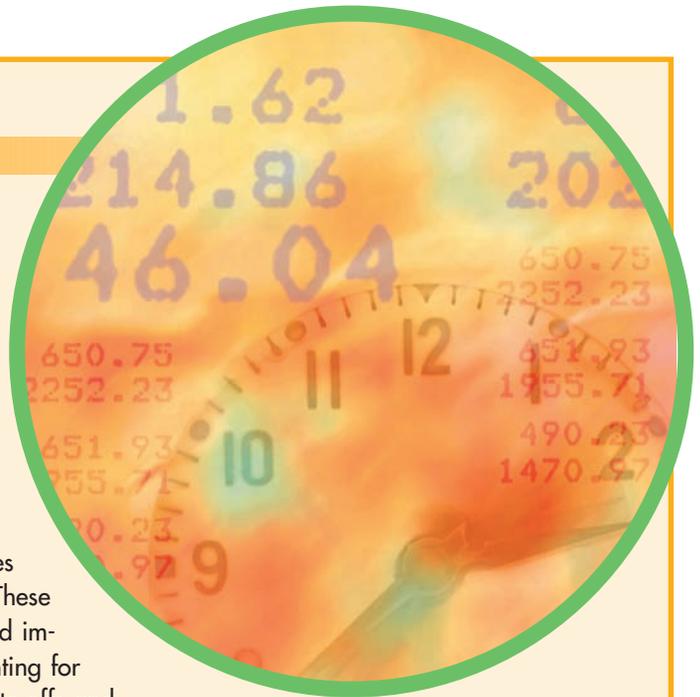
- **Policy Management Systems**, which makes insurance software, said that it reported some sales before contracts were signed or products delivered.
- **Sunbeam Corporation**, while under the control of the (in)famous “Chainsaw” Al Dunlap, prematurely booked revenues and recorded overly large restructuring charges. Ultimately, the company was forced to restate its net income figures, and Mr. Dunlap lost his job.
- **Rent-Way, Inc.**, which owns a large chain of rent-to-own stores,

saw its share price plummet from \$23.44 down to \$5 within a week after it disclosed what the company termed “fictitious” accounting entries on its books. These entries included improper accounting for fixed-asset write-offs and understating the amount of damaged or missing merchandise.

Often in cases such as these, the company’s stockholders sue the company because of the decline in the stock price owing to disclosure of the misinformation. In light of this eventuality, why might management want to report revenues or expenses in the wrong period? Company managers are under intense pressure to report higher earnings every year. If

actual performance falls short of expectations, management might be tempted to bend the rules.

One analyst suggests that investors and auditors should be suspicious of sharp increases in monthly sales at the end of each quarter or big jumps in fourth-quarter sales. Such events don’t always mean management is cheating, but they are certainly worth investigating.



S T U D Y O B J E C T I V E S

After studying this chapter, you should be able to

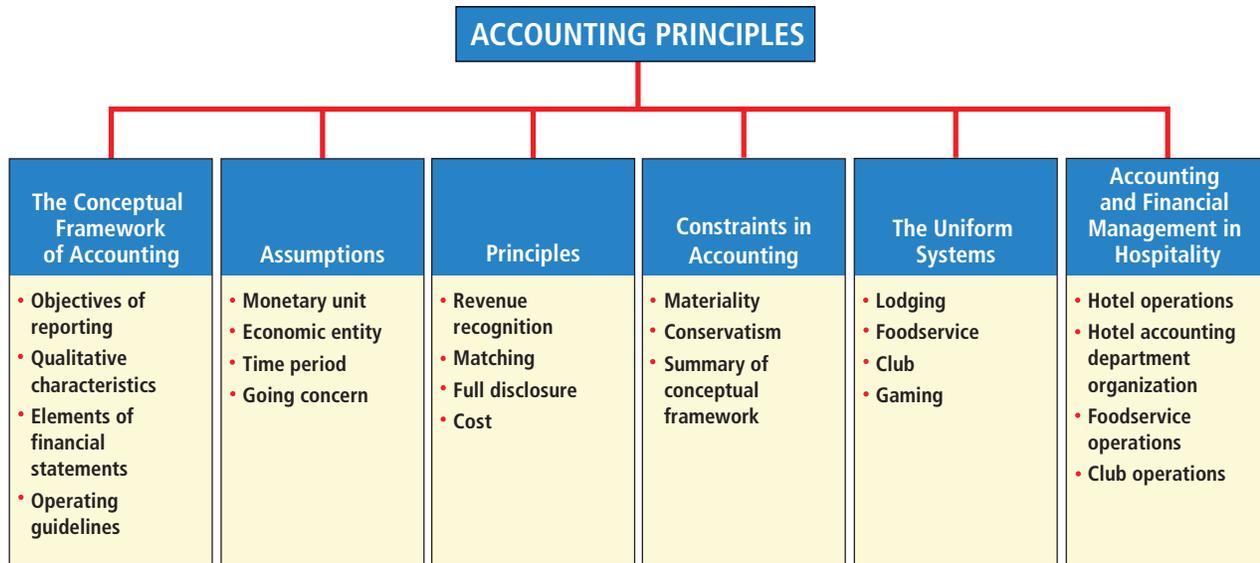
1. Explain the meaning of generally accepted accounting principles and identify the key items of the conceptual framework.
2. Describe the basic objectives of financial reporting.
3. Discuss the qualitative characteristics of accounting information and elements of financial statements.
4. Identify the basic assumptions used by accountants.
5. Identify the basic principles of accounting.
6. Identify the two constraints in accounting.
7. Explain the accounting principles used in international operations.
8. Analyze the effects of business transactions on the basic accounting equation.
9. Understand what the four financial statements are and how they are prepared.



PREVIEW OF CHAPTER 2

As indicated in the Feature Story, it is important that general guidelines be available to resolve accounting issues. Without these basic guidelines, each enterprise would have to develop its own set of accounting practices. If this happened, we would have to become familiar with every company's peculiar accounting and reporting rules in order to understand their financial statements. It would be difficult, if not impossible, to compare the financial statements of different companies. This chapter explores the basic accounting principles used in developing specific accounting guidelines. The Uniform Systems of Accounts used in hospitality accounting reporting is also discussed.

The content and organization of Chapter 2 are as follows:



THE CONCEPTUAL FRAMEWORK OF ACCOUNTING

STUDY OBJECTIVE 1

Explain the meaning of generally accepted accounting principles and identify the key items of the conceptual framework.

What you have learned up to this point in the book is a process that leads to the preparation of financial reports about a company. These are the company's financial statements. This area of accounting is called **financial accounting**. The accounting profession has established a set of standards and rules that are recognized as a general guide for financial reporting. This recognized set of standards is called **generally accepted accounting principles (GAAP)**. *Generally accepted* means that these principles must have "substantial authoritative support." Such support usually comes from two standard-setting bodies: the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).¹

¹The SEC is an agency of the U.S. government that was established in 1933 to administer laws and regulations relating to the exchange of securities and the publication of financial information by U.S. businesses. The agency has the authority to mandate generally accepted accounting principles for companies under its jurisdiction. However, throughout its history, the SEC has been willing to accept the principles set forth by the FASB and similar bodies.

Since the early 1970s, the business and governmental communities have given the FASB the responsibility for developing accounting principles in the United States. This is an ongoing process; accounting principles change to reflect changes in the business environment and in the needs of users of accounting information.

Prior to the establishment of the FASB, accounting principles were developed on a problem-by-problem basis. Rule-making bodies developed accounting rules and methods to solve specific problems. Critics charged that the problem-by-problem approach led over time to inconsistent rules and practices. No clearly developed conceptual framework of accounting existed to refer to in solving new problems.

In response to these criticisms, the FASB developed a **conceptual framework**. It serves as the basis for resolving accounting and reporting problems. The FASB spent considerable time and effort on this project. The board views its conceptual framework as “a constitution, a coherent system of interrelated objectives and fundamentals.”²

The FASB’s conceptual framework consists of four items:

1. Objectives of financial reporting
2. Qualitative characteristics of accounting information
3. Elements of financial statements
4. Operating guidelines (assumptions, principles, and constraints)

We will discuss these items on the following pages.

HELPFUL HINT

Accounting principles are affected by economic and political conditions that change over time. As a result, accounting principles are not cut into stone like the periodic table in chemistry or a formula in math.

ACCOUNTING IN ACTION *International Insight*



Different political and cultural influences affect the accounting that occurs in foreign countries. For example, in Sweden, accounting is considered an instrument to be used to shape fiscal policy. In Europe, generally, more emphasis is given to social reporting (more information on employment statistics, health of workers, and so on) than in the United States. European labor organizations are strong and demand that type of information from management.



OBJECTIVES OF FINANCIAL REPORTING

The FASB began to work on the conceptual framework by looking at the objectives of financial reporting. Determining these objectives required answers to such basic questions as Who uses financial statements? Why? What information do they need? How knowledgeable about business and accounting are financial statement users? How should financial information be reported so that it is best understood?

In answering these questions, the FASB concluded that financial reporting should have three objectives:

1. The information is useful to those making investment and credit decisions.
2. The financial reports are helpful in assessing future cash flows.
3. The economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims are clearly identified.

The FASB then undertook to describe the characteristics that make accounting information useful.

STUDY OBJECTIVE 2

Describe the basic objectives of financial reporting.

²“Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement,” *FASB Discussion Memorandum* (Stamford, CT: 1976), p. 1.

STUDY OBJECTIVE 3

Discuss the qualitative characteristics of accounting information and elements of financial statements.

HELPFUL HINT

What makes accounting information relevant? Answer: Relevant accounting information provides feedback, serves as a basis for predictions, and is timely (current).

HELPFUL HINT

What makes accounting information reliable? Answer: Reliable accounting information is free of error and bias and is factual, verifiable, and neutral.

QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

How does a company like the **Club Corporation of America** decide on the amount of financial information to disclose? In what format should its financial information be presented? How should assets, liabilities, revenues, and expenses be measured? The FASB concluded that the overriding criterion for such accounting choices is **decision usefulness**. The accounting practice selected should be the one that generates the most useful financial information for making a decision. To be useful, information should possess the following qualitative characteristics: relevance, reliability, comparability, and consistency.

Relevance

Accounting information has **relevance** if it makes a difference in a decision. Relevant information has either predictive or feedback value or both. **Predictive value** helps users forecast future events. For example, when **Four Seasons Hotels & Resorts** issues financial statements, the information in them is considered relevant because it provides a basis for predicting future earnings. **Feedback value** confirms or corrects prior expectations. When **Four Seasons** issues financial statements, it confirms or corrects prior expectations about the financial health of the company.

In addition, accounting information has relevance if it is **timely**. It must be available to decision makers before it loses its capacity to influence decisions. If **Four Seasons** reported its financial information only every five years, the information would be of limited use in decision making.

Reliability

Reliability of information means that the information is free of error and bias. In short, it can be depended on. To be reliable, accounting information must be **verifiable**: We must be able to prove that it is free of error and bias. It also must be a **faithful representation** of what it purports to be: It must be factual. If the **Felcor Lodging Trust** balance sheet reports assets of \$8 billion when it had assets of \$51 billion, then the statement is not a faithful representation. Finally, accounting information must be **neutral**: It cannot be selected, prepared, or presented to favor one set of interested users over another. To ensure reliability, certified public accountants audit financial statements.

Comparability

Accounting information about an enterprise is most useful when it can be compared with accounting information about other enterprises. **Comparability** results when different companies use the same accounting principles. For example, **Accor** and **Adam's Mark** use the cost principle in reporting plant assets on the balance sheet. Also, each company uses the revenue recognition and matching principles in determining its net income.

Conceptually, comparability also should extend to the methods used by companies in complying with an accounting principle. Accounting methods include the first-in, first-out (FIFO) and last-in, first-out (LIFO) methods of inventory costing and various depreciation methods. At this point, comparability of methods is not required, even for companies in the same industry. Thus **LaQuinta Inns and Suites** and **Choice Hotels International** may use different inventory costing and depreciation methods in their financial statements. The only accounting requirement is that each company **must disclose** the accounting methods used. From the

disclosures, the external user can determine whether the financial information is comparable.

Consistency

Consistency means that a company uses the same accounting principles and methods from year to year. If a company selects FIFO as the inventory costing method in the first year of operations, it is expected to use FIFO in succeeding years. When financial information has been reported on a consistent basis, the financial statements permit meaningful analysis of trends within a company.

A company *can* change to a new method of accounting. To do so, management must justify that the new method results in more meaningful financial information. In the year in which the change occurs, the change must be disclosed in the notes to the financial statements. Such disclosure makes users of the financial statements aware of the lack of consistency.

ACCOUNTING IN ACTION Business Insight



There is a classic story that professors often tell students about a company looking for an accountant. The company approached the first accountant and asked, “What do you believe our net income will be this year?” The accountant said, “Four million dollars.” The company asked the second accountant the same question, and the answer was, “What would you like it to be?” Guess who got the job?

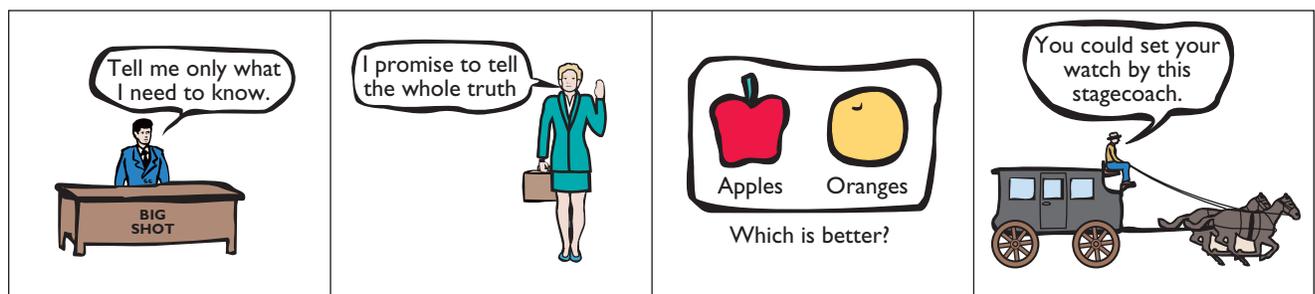
The reason we tell the story here is that because accounting principles offer flexibility, it is important that a consistent treatment be provided from period to period. Otherwise, it would be very difficult to interpret financial statements. Perhaps *no* alternative methods should be permitted in accounting. What do you think?

	Y.Y.	5	REPT. 52
NUMBER OF ROOMS	95		95
TREAS. NETS AVAIL. OF ROOMS	8027		8224
ROOMS SOLD	4630		4298
PERCENT. OF OCCUPANCY	57.8%	57.3%	59.4%
NET AVERAGE ROOM RATE	85.73		82.03
REVENUE			
ROOMS	398,823	26.9%	106,470
FOOD	753,744	51.4%	186,162
BEVERAGES	27,743	1.3%	15,000
GIFT SHOP	23,045	1.6%	7,899
PUBLIC ROOM RENTALS	118,084	8.0%	34,103
AUDIO & VIDEO	40,804	2.5%	10,921
TELEPHONE	4,636		1,748
GARAGE	62,217		20,488
COPY, FAX	12,305		3,810
VALET, DISCRET. PARKING ETC.	1,653		559
OTHER INCOME - TOTAL	80,783	5.3%	28,586
TOTAL NET INCOME	1,479,872	100.0%	306,070

The qualitative characteristics of accounting information are summarized in Illustration 2-1.

Illustration 2-1

Characteristics of useful information



Relevance
 1. Provides a basis for forecasts
 2. Confirms or corrects prior expectations
 3. Is timely

Reliability
 1. Is verifiable
 2. Is a faithful representation
 3. Is neutral

Comparability
 Different companies use similar accounting principles

Consistency
 Company uses same accounting methods from year to year

ELEMENTS OF FINANCIAL STATEMENTS

An important part of the accounting conceptual framework is a set of definitions that describe the basic terms used in accounting. The FASB refers to this set of definitions as the **elements of financial statements**. They include such terms as *assets, liabilities, equity, revenues, and expenses*.

Because these elements are so important, it is crucial that they be precisely defined and universally applied. Finding the appropriate definition for many of these elements is not easy. For example, should the value of a company's employees be reported as an asset on a balance sheet? Should the death of the company's president be reported as a loss? A good set of definitions should provide answers to these types of questions. Because you have already encountered most of these definitions in Chapter 1, they are not repeated here.

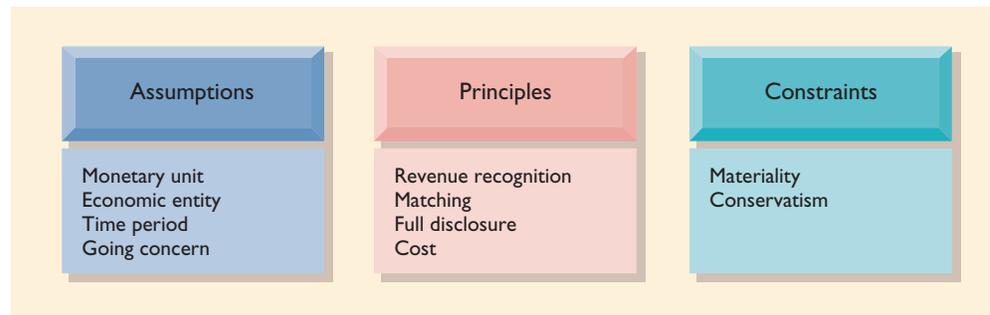
OPERATING GUIDELINES

The objectives of financial reporting, the qualitative characteristics of accounting information, and the elements of financial statements are very broad. Because practicing accountants must solve practical problems, more detailed guidelines are needed. In its conceptual framework, the FASB recognized the need for operating guidelines. We classify these guidelines as assumptions, principles, and constraints. These guidelines are well established and accepted in accounting.

Assumptions provide a foundation for the accounting process. **Principles** are specific rules that indicate how economic events should be reported in the accounting process. **Constraints** on the accounting process allow for a relaxation of the principles under certain circumstances. Illustration 2-2 provides a roadmap of the operating guidelines of accounting. These guidelines (some of which you know from Chapter 1) are discussed in more detail in the following sections.

Illustration 2-2

The operating guidelines of accounting



BEFORE YOU GO ON...

▶ REVIEW IT

1. What are generally accepted accounting principles?
2. What is stated about generally accepted accounting principles in the Report of Independent Public Accountants for **PepsiCo**?
3. What are the basic objectives of financial information?
4. What are the qualitative characteristics that make accounting information useful? Identify two elements of the financial statements.



STUDY OBJECTIVE 4

Identify the basic assumptions used by accountants.

ASSUMPTIONS

As noted earlier, assumptions provide a foundation for the accounting process. Following are definitions of four basic accounting assumptions.

MONETARY UNIT ASSUMPTION

The **monetary unit assumption** states that only transaction data that can be expressed in terms of money should be included in the accounting records. For example, the value of a company president is not reported in a company's financial records because it cannot be expressed easily in dollars.

An important corollary to the monetary unit assumption is the assumption that the unit of measure remains relatively constant over time. This point will be discussed in more detail later in this chapter.

ECONOMIC ENTITY ASSUMPTION

The **economic entity assumption** states that the activities of the entity should be kept separate and distinct from the activities of the owners and of all other economic entities. For example, it is assumed that the activities of **Peabody Hotel Group** can be distinguished from those of other companies, such as **Cendant, Forte Hotels**, and **John Q. Hammons Hotels**.

TIME PERIOD ASSUMPTION

The **time period assumption** states that the economic life of a business can be divided into artificial time periods. Thus it is assumed that the activities of business enterprises such as **MeriStar Hotels and Resorts, Ameri Suites, Carlson Hospitality**, or any enterprise can be subdivided into months, quarters, or a year for meaningful financial reporting purposes.

GOING CONCERN ASSUMPTION

The **going concern assumption** assumes that the enterprise will continue in operation long enough to carry out its existing objectives. Despite numerous business failures, companies have a fairly high continuance rate. It has proved useful to adopt a going concern assumption for accounting purposes.

The accounting implications of this assumption are critical. If a going concern assumption is not used, then plant assets should be stated at their liquidation value (selling price less cost of disposal)—not at their cost. In that case, depreciation and amortization of these assets would not be needed. Each period, these assets simply would be reported at their liquidation value. Also, without this assumption, the current–noncurrent classification of assets and liabilities would not matter. Labeling anything as “long term” would be difficult to justify.

Acceptance of the going concern assumption gives credibility to the cost principle. Only when liquidation appears imminent is the going concern assumption inapplicable. In that case, assets would be better stated at liquidation value than at cost.

These basic accounting assumptions are illustrated graphically in Illustration 2-3 on the next page.

INTERNATIONAL NOTE

In an action that sent shock waves through the French business community, the CEO of Alcatel-Alsthom was taken into custody for an apparent violation of the economic entity assumption. Allegedly, the executive improperly used company funds to install an expensive security system in his home.

HELPFUL HINT

(1) Which accounting assumption assumes that an enterprise will remain in business long enough to recover the cost of its assets? (2) Which accounting assumption is justification for the cost principle? Answers: (1) and (2) Going concern assumption.

PRINCIPLES

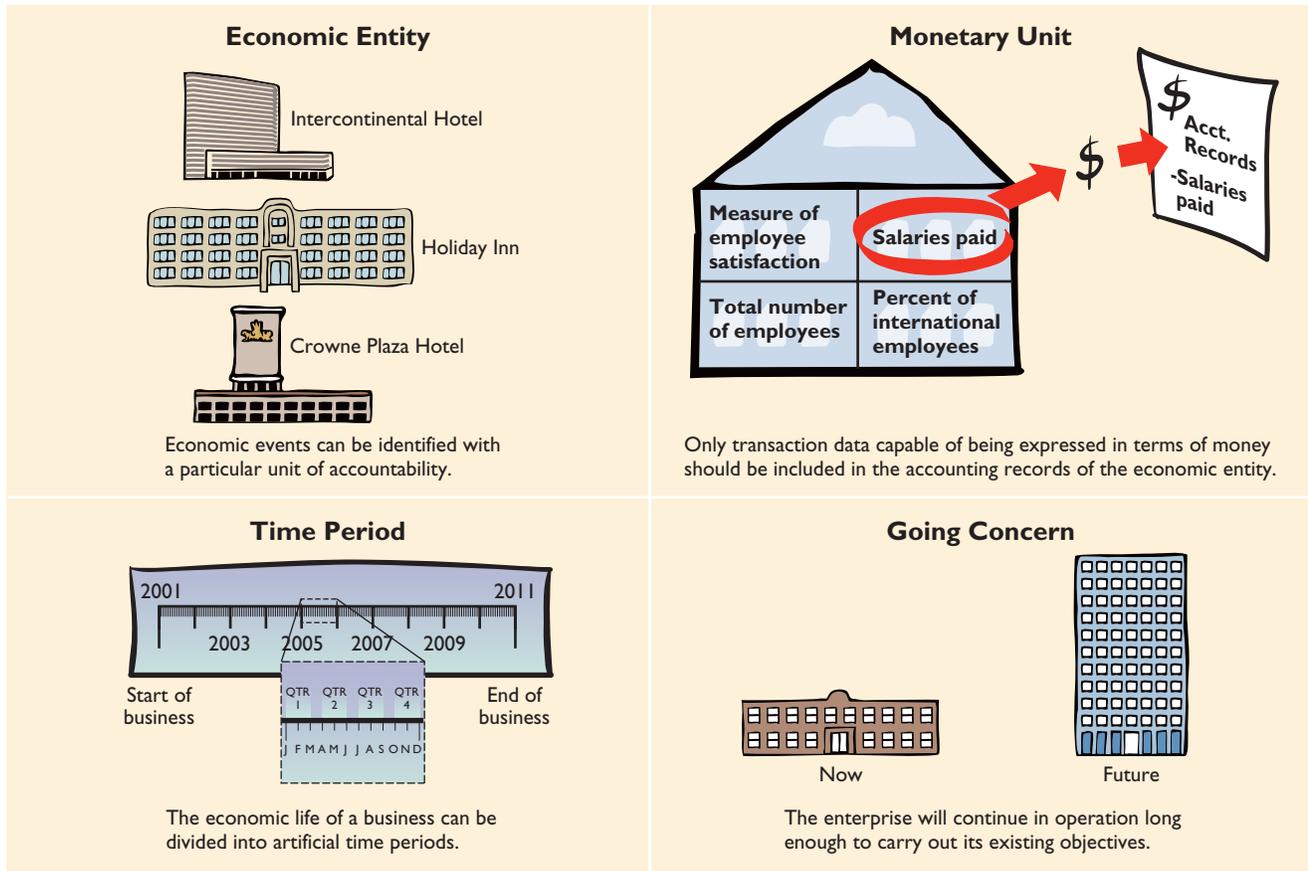
On the basis of the fundamental assumptions of accounting, the accounting profession has developed principles that dictate how economic events should be recorded and reported. In Chapter 1 we discussed the cost principle, and we will also discuss the revenue recognition and matching principles in Chapter 4. Here, we examine a number of reporting issues related to these principles. In addition, we introduce another principle, the full disclosure principle.

STUDY OBJECTIVE 5

Identify the basic principles of accounting.

Illustration 2-3

Assumptions used in accounting



REVENUE RECOGNITION PRINCIPLE

The **revenue recognition principle** dictates that revenue should be recognized in the accounting period in which it is earned. But applying this general principle in practice can be difficult. Some companies improperly recognize revenue on goods that have not been shipped to customers. Similarly, until recently, financial institutions immediately recorded a large portion of their loan fees as revenue rather than spreading those fees over the life of the loan.

When a sale is involved, revenue is recognized at the point of sale. This **sales basis** involves an exchange transaction between the seller and the buyer. The sales price is an objective measure of the amount of revenue realized. However, two exceptions to the sales basis for revenue recognition have become generally accepted—the percentage-of-completion method and the installment method. These methods are left for more advanced courses.

MATCHING PRINCIPLE (EXPENSE RECOGNITION)

Expense recognition traditionally is tied to revenue recognition: “Let the expense follow the revenue.” As you will learn in Chapter 4, this practice is referred to as the **matching principle**. It dictates that expenses be matched with revenues in the period in which efforts are made to generate revenues. Expenses are not recognized when cash is paid, or when the work is performed, or when the product is produced. Rather, they are recognized when the labor (service) or the product actually makes its contribution to revenue.

HELPFUL HINT

Revenue should be recognized in the accounting period in which it is earned. This may not be the period in which the related cash is received. In a retail establishment, the point of sale is often the critical point in the process of earning revenue.

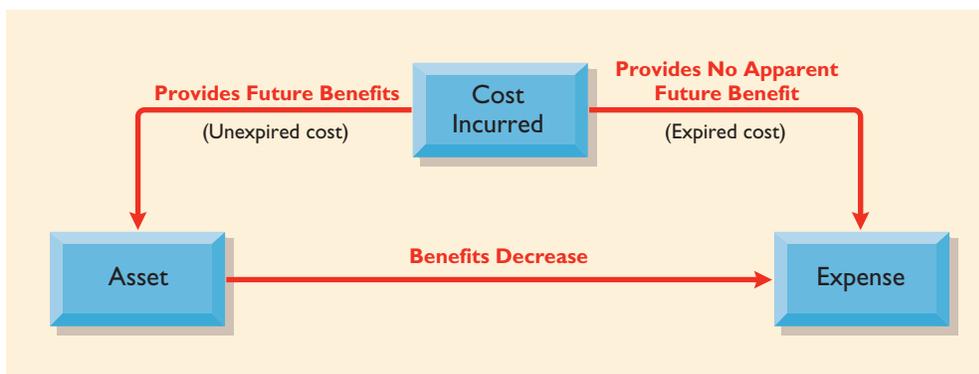
But, it is sometimes difficult to determine the accounting period in which the expense contributed to revenues. Several approaches have therefore been devised for matching expenses and revenues on the income statement.

To understand these approaches, you need to understand the nature of expenses. Costs are the source of expenses. Costs that will generate revenues only in the current accounting period are expensed immediately. They are reported as **operating expenses** in the income statement. Examples include costs for advertising, sales salaries, and repairs. These expenses are often called **expired costs**.

Costs that will generate revenues in future accounting periods are recognized as assets. Examples include merchandise inventory, prepaid expenses, and plant assets. These costs represent **unexpired costs**. Unexpired costs become expenses in two ways:

1. **Cost of goods sold.** Costs carried as merchandise inventory become expenses when the inventory is sold. They are expensed as cost of goods sold in the period when the sale occurs. Thus, there is a direct matching of expenses with revenues.
2. **Operating expenses.** Other unexpired costs become operating expenses through use or consumption (as in the case of store supplies) or through the passage of time (as in the case of prepaid insurance). The costs of plant assets and other long-lived resources are expensed through rational and systematic allocation methods—periodic depreciation or amortization. Operating expenses contribute to the revenues for the period, but their association with revenues is less direct than for cost of goods sold.

These points about expense recognition are illustrated in Illustration 2-4.



HELPFUL HINT

Costs become expenses when they are charged against revenue.

ETHICS NOTE

Many appear to do it, but few like to discuss it: It's earnings management, and it's a clear violation of the revenue recognition and matching principles. Banks sometimes time the sale of investments or the expensing of bad debts to accomplish earnings objectives. Prominent companies have been accused of matching one-time gains with one-time charge-offs so that current-period earnings are not so high that they can't be surpassed next period.

Illustration 2-4

Expense recognition pattern

ACCOUNTING IN ACTION *Business Insight*



Implementing expense recognition guidelines can be difficult. Consider, for example, **Harold's Club** (a gambling casino) in Reno, Nevada. How should it report expenses related to the payoff of its progressive slot machines? Progressive slot machines, which generally have no ceiling on their jackpots, provide a lucky winner with all the money that many losers had previously put in. Payoffs tend to be huge but infrequent. At Harold's, the progressive slots pay off on average every 4½ months.

The basic accounting question is: Can Harold's deduct the millions of dollars sitting in its progressive slot machines from the revenue recognized at the end of the accounting period? One might argue that no, you cannot deduct the money until the "winning handle pull." However, a winning handle pull might not occur for many months or even years. Although an estimate would have to be used, the better answer is to match these costs with the revenue recognized, assuming that an average 4½ months' payout is well documented.

What accounting principles are applicable to the Harold's Club progressive slot machines? If Harold's fails to use an estimate for expenses, what effect will this have on financial statements in a period when no payouts occur?



FULL DISCLOSURE PRINCIPLE

The **full disclosure principle** requires that circumstances and events that make a difference to financial statement users be disclosed. For example, most accountants would agree that hospitality companies should disclose any liability suits pending against them. Interested parties would want to be made aware of this contingent loss. Similarly, it is generally agreed that companies should disclose the major provisions of employee pension plans and long-term lease contracts.

Compliance with the full disclosure principle occurs through the data in the financial statements and the information in the notes that accompany the statements. The first note in most cases is a **summary of significant accounting policies**. It includes, among others, the methods used for inventory costing, depreciation of plant assets, and amortization of intangible assets.

Deciding how much disclosure is enough can be difficult. Accountants could disclose every financial event that occurs and every contingency that exists. But the benefits of providing additional information in some cases may be less than the costs of doing so. Many companies complain of an accounting standards overload. They also object to requirements that force them to disclose confidential information. Determining where to draw the line on disclosure is not easy.

One thing is certain: Financial statements were much simpler years ago. In 1930, **General Electric** had no notes to its financial statements. Today, it has more than twenty pages of notes! Why this change? A major reason is that the objectives of financial statements have changed. In the past, information was generally presented on what the business had done. Today, the objectives of financial reporting are more future-oriented. The goal is to provide information that makes it possible to predict the amounts, timing, and uncertainty of future cash flows.



ACCOUNTING IN ACTION Business Insight



Some accountants are reconsidering the current means of financial reporting. They propose a database concept of financial reporting. In such a system, all the information from transactions would be stored in a computerized database to be instantly accessed by various user groups. The main benefit of such a system is the ability to tailor the information requested to the needs of each user on a real-time basis.

What makes this idea controversial? Discussion currently revolves around access and aggregation issues. Questions abound: “Who should be allowed to make inquiries of the system?” “What is the lowest/smallest level of information to be provided?” “Will such a system necessarily improve on the current means of disclosure?” Such questions must be answered before database financial accounting can be implemented on a large scale.

Would instant access to financial information provide more relevant information? Do you think such an approach would do away with the need for annual reports?

COST PRINCIPLE

The **cost principle** dictates that assets be recorded at their cost. Cost is used because it is both relevant and reliable. Cost is **relevant** because it represents the price paid, the assets sacrificed, or the commitment made at date of acquisition. Cost is **reliable** because it is objectively measurable, factual, and verifiable. It is the result of an exchange transaction. Cost is the basis used in preparing financial statements.

The relevance of the cost principle, however, has come under criticism. After acquisition, the argument goes, the cost of an asset is not equivalent to market value or current value. Also, as the purchasing power of the dollar changes, so does the meaning associated with the dollar used as the basis of measurement. Con-

sider the classic story about the individual who went to sleep and woke up 10 years later. Hurrying to a telephone, he called his broker and asked what his formerly modest stock portfolio was worth. He was told that he was a multimillionaire. His **Starwood** stock was worth \$5 million, and his **Hilton** stock was up to \$10 million. Elated, he was about to inquire about his other holdings, when the telephone operator cut in with “Your time is up. Please deposit \$100,000 for the next three minutes.”³

HELPFUL HINT

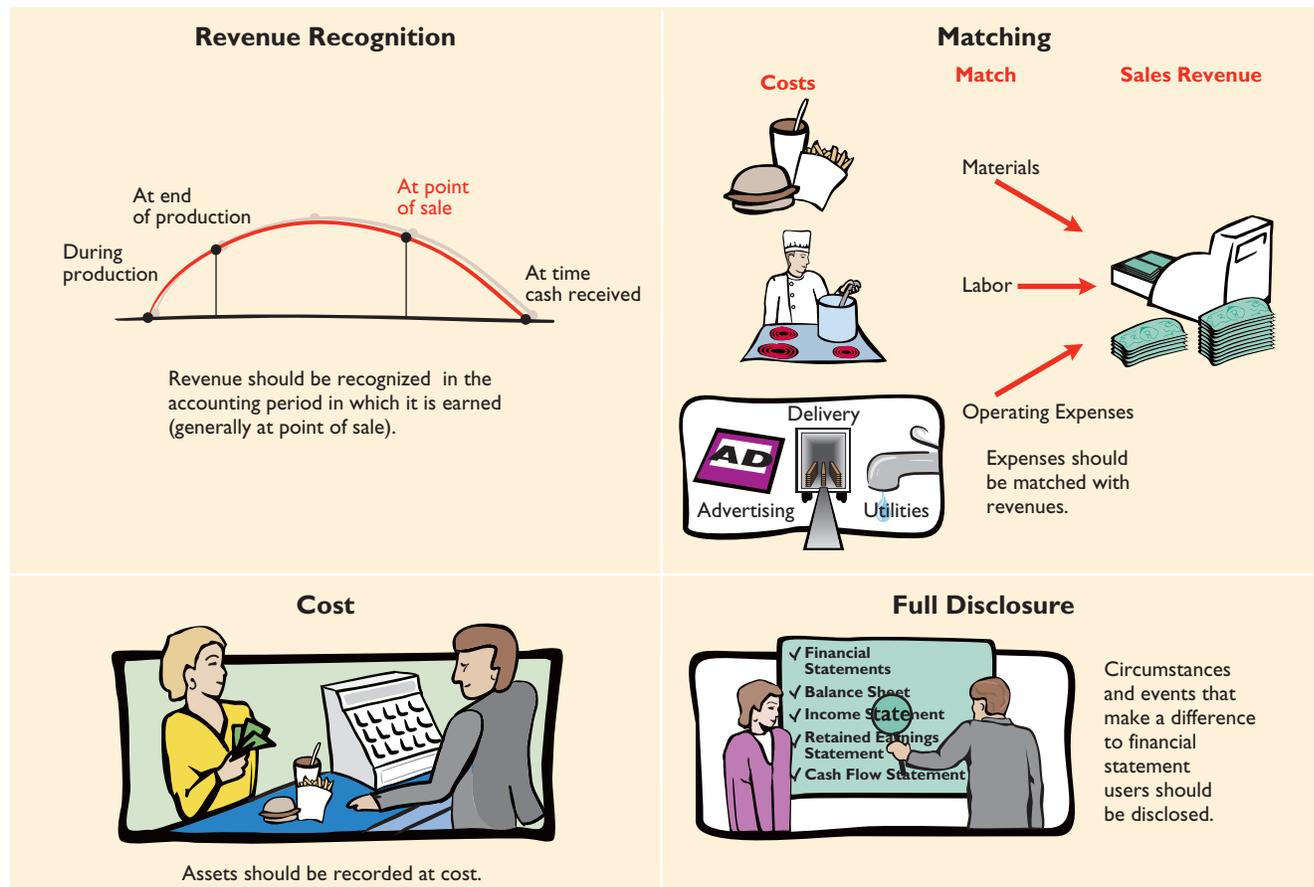
Are you a winner or loser when you hold cash in a period of inflation? Answer: A loser, because the value of the cash declines as inflation climbs.

Despite the inevitability of changing prices owing to inflation, the accounting profession still follows the stable monetary unit assumption in preparing the primary financial statements. While admitting that some changes in prices do occur, the profession believes the unit of measure—the dollar—has remained sufficiently constant over time to provide meaningful financial information. *Sometimes the disclosure of price-level adjusted data is in the form of supplemental information that accompanies the financial statements.*

Illustration 2-5

Basic principles used in accounting

The basic principles of accounting are summarized in Illustration 2-5.



CONSTRAINTS IN ACCOUNTING

Constraints permit a company to modify generally accepted accounting principles without reducing the usefulness of the reported information. The constraints are materiality and conservatism.

STUDY OBJECTIVE 6

Identify the two constraints in accounting.

³Adapted from *Barron's* (January 28, 1980), p. 27.

MATERIALITY

Materiality relates to an item's impact on a firm's overall financial condition and operations. An item is **material** when it is likely to influence the decision of a reasonably prudent investor or creditor. It is immaterial if its inclusion or omission has no impact on a decision maker. In short, if the item does not make a difference in decision making, GAAP do not have to be followed. To determine the materiality of an amount, the accountant usually compares it with such items as total assets, total liabilities, and net income.

To illustrate how the materiality constraint is applied, assume that Rodriguez Co. purchases a number of low-cost plant assets, such as wastepaper baskets. Although the proper accounting would appear to be to depreciate these wastepaper baskets over their useful life, they are usually expensed immediately. This practice is justified because these costs are considered immaterial. Establishing depreciation schedules for these assets is costly and time-consuming and will not make a material difference on total assets and net income. Another application of the materiality constraint would be the expensing of small tools. Some companies expense any plant assets under a specified dollar amount.

CONSERVATISM

The **conservatism** constraint dictates that when in doubt, choose the method that will be least likely to overstate assets and income. *It does not mean understating assets or income.* Conservatism provides a reasonable guide in difficult situations: Do not overstate assets and income.

A common application of the conservatism constraint is the use of the lower of cost or market method for inventories. As Chapter 9 will show, inventories are reported at market value if market value is below cost. This practice results in a higher cost of goods sold and lower net income. In addition, inventory on the balance sheet is stated at a lower amount.

Other examples of conservatism in accounting are the use of the last-in, first-out (LIFO) method for inventory valuation when prices are rising and the use of accelerated depreciation methods for plant assets. Both these methods result in lower asset-carrying values and lower net income than alternative methods.

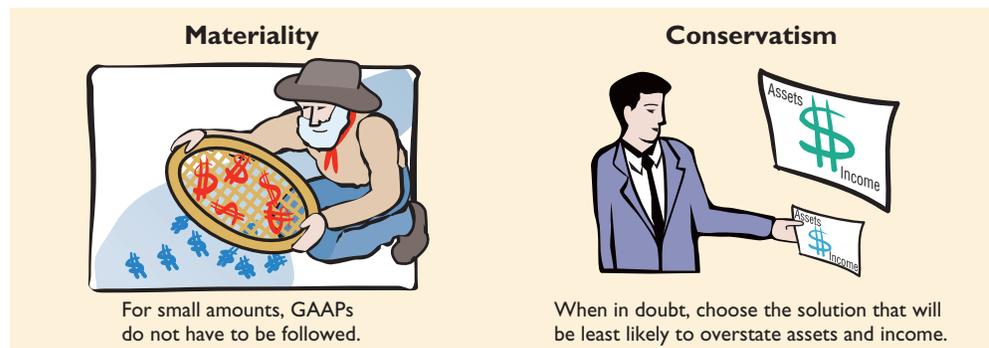
The two constraints in accounting are graphically depicted in Illustration 2-6.

HELPFUL HINT

In other words, if two methods are otherwise equally appropriate, choose the one that will least likely overstate assets and income.

Illustration 2-6

Constraints in accounting



SUMMARY OF CONCEPTUAL FRAMEWORK

As we have seen, the conceptual framework for developing sound reporting practices starts with a set of objectives for financial reporting. It follows with the description of qualities that make information useful. In addition, elements of financial statements are defined. More detailed operating guidelines are then provided. These guidelines take the form of assumptions and principles. The

conceptual framework also recognizes that constraints exist on the reporting environment. The conceptual framework is illustrated graphically in Illustration 2-7.

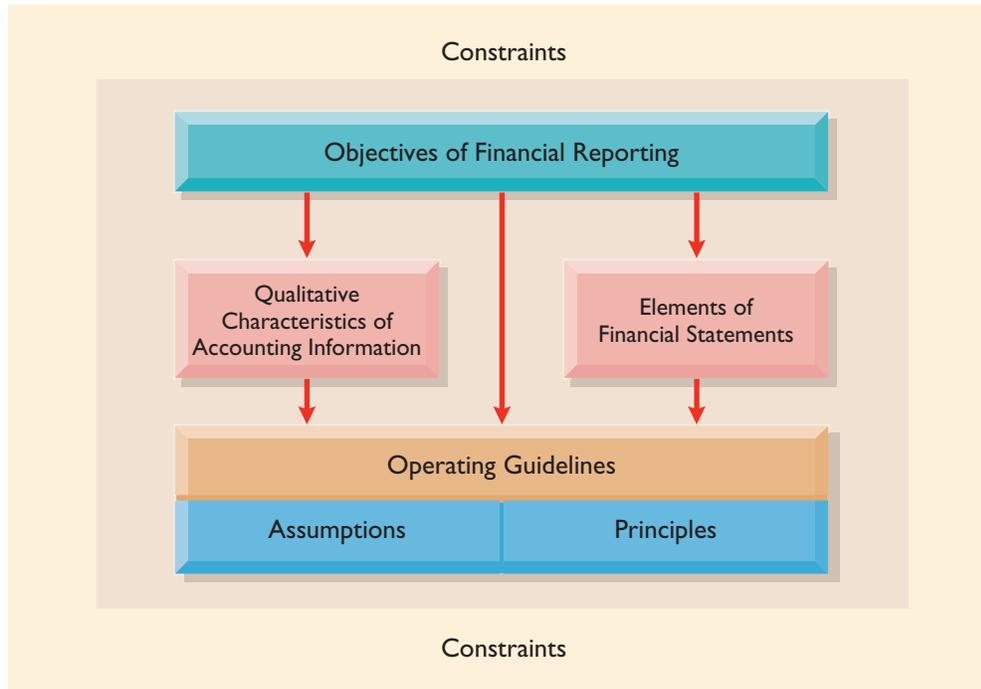


Illustration 2-7

Conceptual framework

BEFORE YOU GO ON...

▶ REVIEW IT

1. What are the monetary unit assumption, the economic entity assumption, the time period assumption, and the going concern assumption?
2. What are the revenue recognition principle, the matching principle, the full disclosure principle, and the cost principle?
3. What are the materiality constraint and the conservatism constraint?



FINANCIAL STATEMENT PRESENTATION— AN INTERNATIONAL PERSPECTIVE

World markets are becoming increasingly intertwined. Foreigners use American computers, eat American breakfast cereals, read American magazines, listen to American rock music, watch American movies and TV shows, and drink American soda. Americans drive Japanese cars, wear Italian shoes and Scottish woolens, drink Brazilian coffee and Indian tea, eat Swiss chocolate bars, sit on Danish furniture, and use Arabian oil. The variety and volume of exported and imported goods indicate the extensive involvement of U.S. business in international trade. Many U.S. companies consider the world their market.

Firms that conduct operations in more than one country through subsidiaries, divisions, or branches in foreign countries are referred to as **multinational corporations (MNCs)**. The accounting for such corporations is complicated because

STUDY OBJECTIVE 7

Explain the accounting principles used in international operations.

foreign currencies are involved. These international transactions must be translated into U.S. dollars.

Differences in Standards

In the new global economy many investment and credit decisions require the analysis of foreign financial statements. Unfortunately, accounting standards are not uniform from country to country. This lack of uniformity results from differences in legal systems, in processes for developing accounting standards, in governmental requirements, and in economic environments.



ACCOUNTING MATTERS! *International Insight*



Research and development costs are an example of different international accounting standards. Compare how four countries account for research and development (R&D):

Country	Accounting Treatment
United States	Expenditures are expensed.
United Kingdom	Certain expenditures may be capitalized.
Germany	Expenditures are expensed.
Japan	Expenditures may be capitalized and written off over 5 years.

Thus, an R&D expenditure of \$100 million is charged totally to expense in the current period in the United States and Germany. This same expense could range from zero to \$100 million in the United Kingdom and from \$20 million to \$100 million in Japan!

What would be the advantage of similar accounting standards for all countries? How can the financial and operating performance of international companies be compared?

Uniformity in Standards

Efforts to obtain uniformity in international accounting practices are taking place. In 1973 the **International Accounting Standards Committee (IASC)** was formed by agreement of accounting organizations in the United States, the United Kingdom, Canada, Australia, France, Germany, Japan, Mexico, and the Netherlands. Its purpose is to formulate international accounting standards and to promote their acceptance worldwide.

To date, numerous standards have been issued for IASC members to introduce to their respective countries. But the IASC has no enforcement powers, so these standards are by no means universally applied. They are, though, generally followed by the multinational companies that are audited by international public accounting firms. The foundation has been laid for progress toward greater uniformity in international accounting.

STUDY OBJECTIVE 8

Analyze the effects of business transactions on the basic accounting equation.

USING THE BUILDING BLOCKS

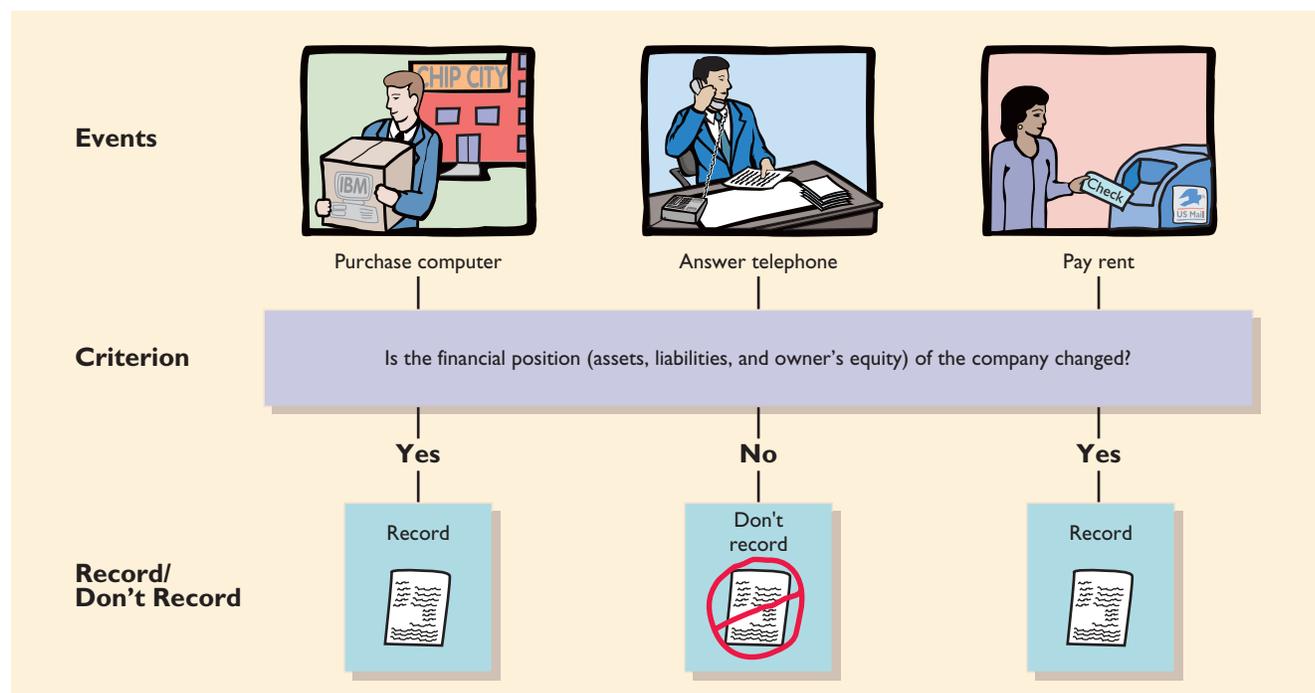
Transactions (often referred to as business transactions) are the economic events of an enterprise that are recorded. Transactions may be identified as external or internal. **External transactions involve economic events between the company and**

some outside enterprise. For example, Campus Pizza's purchase of cooking equipment from a supplier, payment of monthly rent to the landlord, and sale of pizzas to customers are external transactions. **Internal transactions are economic events that occur entirely within one company.** The use of cooking and cleaning supplies illustrates internal transactions for Campus Pizza.

A company may carry on many activities that do not in themselves represent business transactions. Hiring employees, answering the telephone, talking with customers, and placing orders for merchandise are examples. Some of these activities, however, may lead to business transactions: Employees will earn wages, and merchandise will be delivered by suppliers. Each event must be analyzed to find out if it has an effect on the components of the basic accounting equation. If it does, it will be recorded in the accounting process. Illustration 2-8 demonstrates the transaction identification process.

Illustration 2-8

Transaction identification process



The equality of the basic equation must be preserved. Therefore, each transaction must have a dual effect on the equation. For example, if an asset is increased, it must be offset by one or more of the following:

1. Decrease in another asset
2. Increase in a specific liability
3. Increase in owner's/stockholders' equity

It follows that two or more items could be affected when an asset is increased. For example, as one asset is increased \$10,000, another asset could decrease \$6,000, and a specific liability could increase \$4,000. Note also that any change in an individual liability or ownership claim is subject to similar analysis.

TRANSACTION ANALYSIS

The following examples are business transactions for a new catering business during its first month of operations. You will want to study these transactions until you are sure that you understand them. They are not difficult, but they are

important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential for an understanding of accounting.

Transaction (1). Investment by Stockholders

Ray and Barbara Neal decide to open a catering service that they incorporate as Best Caterers, Inc. They invest \$15,000 cash in the business in exchange for \$15,000 of common stock. The common stock indicates the ownership interest that the Neals have in Best Caterers, Inc. The transaction results in an equal increase in both assets and stockholders' equity. In this case there is an increase in the asset Cash of \$15,000 and an increase in Common Stock of \$15,000.

The effect of this transaction on the basic equation is shown below. Recorded to the right of Common Stock is the reason why stockholders' equity changed (i.e., investment).

	<u>Assets</u>	=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>	
	Cash	=			Common Stock	
(1)	+\$15,000	=			+\$15,000	Investment

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in stockholders' equity is indicated, to make clear that the increase is an investment rather than revenue from operations. Why does this matter? Because investments by stockholders do not represent revenues; they are excluded in determining net income. Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations. Additional investments (i.e., investments made by stockholders after the corporation has been initially formed) have the same effect on stockholders' equity as the initial investment.

Transaction (2). Purchase of Equipment for Cash

Best Caterers, Inc., purchases computer equipment for \$7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets is changed: Cash is decreased \$7,000, and the asset Equipment is increased \$7,000. The specific effect of this transaction and the cumulative effect of the first two transactions are

	<u>Assets</u>		=	<u>Liabilities</u>	+	<u>Stockholders' Equity</u>	
	Cash	+	Equipment	=		Common Stock	
Old Bal.	\$ 15,000					\$15,000	
(2)	-7,000		+7,000				
New Bal.	\$ 8,000	+	\$ 7,000	=		\$15,000	
	\$15,000						

Observe that total assets are still \$15,000 and that stockholders' equity also remains at \$15,000, the amount of the original investment.

Transaction (3). Purchase of Supplies on Credit

Best Caterers, Inc., purchases for \$1,600 from Acme Supply Company various supplies expected to last several months. Acme agrees to allow Best Caterers to pay this bill next month, in October. This transaction is often referred to as a purchase on account or a credit purchase. Assets are increased by the transaction because of the expected future benefits of using the paper and supplies, and liabilities are increased by the amount due Acme Company. The asset Supplies is increased \$1,600, and the liability Accounts Payable is increased by the same amount. The effect on the equation is

	Assets			=	Liabilities	+	Stockholders' Equity		
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock
Old Bal.	\$8,000				\$7,000				\$15,000
(3)			+\$1,600				+\$1,600		
New Bal.	\$8,000	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000
	\$16,600						\$16,600		

Total assets are now \$16,600. This total is matched by a \$1,600 creditor's claim and a \$15,000 stockholders' claim.

Transaction (4). Services Rendered for Cash

Best Caterers, Inc., receives \$1,200 cash from customers for catering services it has provided. This transaction represents Best Caterers' principal revenue-producing activity. Recall that **revenue increases stockholders' equity**. Both assets and stockholders' equity are therefore increased. In this transaction, Cash is increased \$1,200, and Retained Earnings is increased \$1,200. The new balances in the equation are

	Assets			=	Liabilities	+	Stockholders' Equity			
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
Old Bal.	\$8,000		\$1,600		\$7,000		\$1,600		\$15,000	
(4)	+\$1,200									+\$1,200 Service Revenue
New Bal.	\$9,200	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	\$1,200
	\$17,800						\$17,800			

The two sides of the equation balance at \$17,800. Note that stockholders' equity is increased when revenues are earned. The source of the increase in stockholders' equity is indicated as Service Revenue. Service Revenue is included in determining the net income of Best Caterers, Inc.

Transaction (5). Purchase of Advertising on Credit

Best Caterers, Inc., receives a bill for \$250 from the *Daily News* for advertising the opening of its business but postpones payment of the bill until a later date. This transaction results in an increase in liabilities and a decrease in stockholders'

equity. The specific items involved are Accounts Payable and Retained Earnings. The effect on the equation is

		Assets			=	Liabilities	+	Stockholders' Equity	
		Cash	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
(5)	Old Bal.	\$9,200	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$1,200
						+250			-250 Advertising Expense
	New Bal.	\$9,200	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$ 950
		\$17,800				\$17,800			

The two sides of the equation still balance at \$17,800. Observe that Retained Earnings is decreased when the expense is incurred, and the specific cause of the decrease (Advertising Expense) is noted. Expenses do not have to be paid in cash at the time they are incurred. When payment is made at a later date, the liability Accounts Payable will be decreased, and the asset Cash will be decreased [see Transaction (8)]. The cost of advertising is considered an expense, as opposed to an asset, because the benefits have been used. This expense is included in determining net income.

Transaction (6). Services Rendered for Cash and Credit

Best Caterers, Inc., provides catering services of \$3,500 for customers. Cash of \$1,500 is received from customers, and the balance of \$2,000 is billed to customers on account. This transaction results in an equal increase in assets and stockholders' equity. Three specific items are affected: Cash is increased \$1,500, Accounts Receivable is increased \$2,000, and Retained Earnings is increased \$3,500. The new balances are

		Assets				=	Liabilities	+	Stockholders' Equity	
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
(6)	Old Bal.	\$ 9,200		\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$ 950
		+1,500	+2,000							+3,500 Service Revenue
	New Bal.	\$10,700	\$2,000	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$4,450
		\$21,300					\$21,300			

Why increase Retained Earnings by \$3,500 when only \$1,500 has been collected? Because the inflow of assets resulting from the earning of revenues does not have to be in the form of cash. Remember that stockholders' equity is increased when revenues are earned; in Best Caterers' case, revenues are earned when the service is provided. When collections on account are received at a later date, Cash will be increased, and Accounts Receivable will be decreased [see Transaction (9)].

Transaction (7). Payment of Expenses

Expenses paid in cash for September are store rent \$600, salaries of employees \$900, and utilities \$200. These payments result in an equal decrease in assets and stockholders' equity. Cash is decreased \$1,700, and Retained Earnings is decreased by the same amount. The effect of these payments on the equation is

	Assets				=	Liabilities	+	Stockholders' Equity	
	Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
Old Bal.	\$10,700	\$2,000	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$4,450
(7)	-1,700								-600
									-900
									-200
New Bal.	\$ 9,000	\$2,000	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$2,750
	\$19,600					\$19,600			

The two sides of the equation now balance at \$19,600. Three lines are required in the analysis to indicate the different types of expenses that have been incurred.

Transaction (8). Payment of Accounts Payable

Best Caterers, Inc., pays its *Daily News* advertising bill of \$250 in cash. Remember that the bill was previously recorded [in Transaction (5)] as an increase in Accounts Payable and a decrease in Retained Earnings. Thus this payment “on account” decreases the asset Cash by \$250 and also decreases the liability Accounts Payable by \$250. The effect of this transaction on the equation is

	Assets				=	Liabilities	+	Stockholders' Equity	
	Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
Old Bal.	\$9,000	\$2,000	\$1,600	\$7,000	=	\$1,850	+	\$15,000	\$2,750
(8)	-250					-250			
New Bal.	\$8,750	\$2,000	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$2,750
	\$19,350					\$19,350			

Observe that the payment of a liability related to an expense that has been incurred previously does not affect stockholders' equity. The expense was recorded in Transaction (5) and should not be recorded again. Neither Common Stock nor Retained Earnings changes as a result of this transaction.

Transaction (9). Receipt of Cash on Account

The sum of \$600 in cash is received from customers who have been billed previously for services [in Transaction (6)]. This transaction does not change total assets, but it changes the composition of those assets. Cash is increased \$600, and Accounts Receivable is decreased \$600. The new balances are

	Assets				=	Liabilities	+	Stockholders' Equity	
	Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
Old Bal.	\$8,700	\$2,000	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$2,750
(9)	+600	-600							
New Bal.	\$9,350	\$1,400	\$1,600	\$7,000	=	\$1,600	+	\$15,000	\$2,750
	\$19,350					\$19,350			

Note that a collection on account for services billed and recorded previously does not affect stockholders' equity. Revenue was already recorded in Transaction (6) and should not be recorded again.

Transaction (10). Dividends

The corporation pays a dividend of \$1,300 in cash to Ray and Barbara Neal, the stockholders of Best Caterers, Inc. This transaction results in an equal decrease in assets and stockholders' equity. Both Cash and Retained Earnings are decreased \$1,300, as shown below:

		Assets				=	Liabilities	+	Stockholders' Equity	
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings
Old Bal.	\$9,350	\$1,400	\$1,600	\$7,000	=	\$1,600		\$15,000		\$2,750
(10)	-1,300				=					-1,300 Dividends
New Bal.	\$8,050	\$1,400	\$1,600	\$7,000	=	\$1,600		\$15,000		\$1,450
		\$18,050							\$18,050	

Note that the dividend reduces retained earnings, which is part of stockholders' equity. Dividends are not expenses. Like stockholders' investments, dividends are excluded in determining net income.

SUMMARY OF TRANSACTIONS**Illustration 2-9**

Tabular summary of Best Caterers, Inc., transactions

The transactions of Best Caterers, Inc., are summarized in Illustration 2-9. The transaction number, the specific effects of the transaction, and the balances after

		Assets				=	Liabilities	+	Stockholders' Equity				
		Cash	Accounts Receivable	Supplies	Equipment	=	Accounts Payable	+	Common Stock	Retained Earnings			
(1)	+\$15,000					=		+	\$15,000	Investment			
(2)	-7,000				+\$7,000	=							
	8,000				7,000	=			15,000				
(3)				+\$1,600		=	+\$1,600						
	8,000		+	1,600	+	7,000	=	1,600	+	15,000			
(4)	+1,200					=				+1,200 Service Revenue			
	9,200		+	1,600	+	7,000	=	1,600	+	15,000	+	1,200	
(5)						=	+250			-250 Advert. Expense			
	9,200		+	1,600	+	7,000	=	1,850	+	15,000	+	950	
(6)	+1,500		+\$2,000			=				+3,500 Service Revenue			
	10,700	+	2,000	+	1,600	+	7,000	=	1,850	+	15,000	+	4,450
(7)	-1,700					=				-600 Rent Expense			
						=				-900 Salaries Expense			
						=				-200 Utilities Expense			
	9,000	+	2,000	+	1,600	+	7,000	=	1,850	+	15,000	+	2,750
(8)	-250					=	-250						
	8,750	+	2,000	+	1,600	+	7,000	=	1,600	+	15,000	+	2,750
(9)	+600		-600			=							
	9,350	+	1,400	+	1,600	+	7,000	=	1,600	+	15,000	+	2,750
(10)	-1,300					=				-1,300 Dividends			
	\$8,050	+	\$1,400	+	\$1,600	+	\$7,000	=	\$1,600	+	\$15,000	+	\$1,450
		\$18,050							\$18,050				

each transaction are indicated. The illustration demonstrates a number of significant facts:

- Each transaction must be analyzed in terms of its effect on
 - the three components of the basic accounting equation.
 - specific types (kinds) of items within each component.
- The two sides of the equation always must be equal.
- The causes of each change in the stockholders' claim on assets must be indicated in the Common Stock and Retained Earnings columns.

There! You made it through transaction analysis. If you feel a bit shaky on any of the transactions, it probably would be a good idea at this point to get up, take a short break, and come back again for a 10-to 15-minute review of the transactions to make sure that you understand them before you go on to the next section.

BEFORE YOU GO ON...

▶ REVIEW IT

- What is an example of an external transaction? What is an example of an internal transaction?
- If an asset increases, what are the three possible effects on the basic accounting equation?

▶ DO IT

A tabular analysis of the transactions made by Roberta Mendez & Co., a decorating consulting firm, for the month of August is shown below. Each increase and decrease in stockholders' equity is explained.

Assets		=	Liabilities	+	Stockholders' Equity	
Cash	+ Office Equipment	=	Accounts Payable	+	Common Stock	+ Retained Earnings
1. +25,000					+25,000	Investment
2.	+7,000		+7,000			
3. +8,000						+8,000 Service Revenue
4. -850						-850 Rent Expense

Describe each transaction that occurred for the month.

ACTION PLAN

- Analyze the tabular analysis to determine the nature and effect of each transaction.
- Keep the accounting equation always in balance.
- Remember that a change in an asset will require a change in another asset, a liability, or stockholders' equity.

SOLUTION

- Stockholders purchased additional shares of stock for \$25,000 cash.
- The company purchased \$7,000 of office equipment on credit.
- The company received \$8,000 of cash in exchange for services performed.
- The company paid \$850 for this month's rent.



FINANCIAL STATEMENTS

STUDY OBJECTIVE 9

Understand what the four financial statements are and how they are prepared.

HELPFUL HINT

The income statement, retained earnings statement, and statement of cash flows are all for a *period of time*, whereas the balance sheet is for a *point* in time.

HELPFUL HINT

There is only one group of notes for the whole set of financial statements rather than separate sets of notes for each financial statement.

ALTERNATIVE TERMINOLOGY

The income statement is sometimes referred to as the *statement of operations*, *earnings statement*, or *profit and loss statement*.

After transactions are identified, recorded, and summarized, four financial statements are prepared from the summarized accounting data:

1. An **income statement** presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time.
2. A **retained earnings statement** summarizes the changes in retained earnings for a specific period of time.
3. A **balance sheet** reports the assets, liabilities, and stockholders' equity of a business enterprise at a specific date.
4. A **statement of cash flows** summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.

Each statement provides management, stockholders, and other interested parties with relevant financial data.

The financial statements of Best Caterers, Inc., and their interrelationships are shown in Illustration 2-10. The statements are interrelated: **(1) Net income of \$2,750 shown on the income statement is added to the beginning balance of retained earnings in the retained earnings statement. (2) Retained earnings of \$1,450 at the end of the reporting period shown in the retained earnings statement is reported on the balance sheet. (3) Cash of \$8,050 on the balance sheet is reported on the statement of cash flows.**

Also, every set of financial statements is accompanied by explanatory notes and supporting schedules that are an integral part of the statements. Examples of these notes and schedules are illustrated in later chapters of this textbook.

Be sure to carefully examine the format and the content of each statement. The essential features of each are briefly described in the following sections.

INCOME STATEMENT

The primary focus of the income statement is to report the success or profitability of the company's operations over a specific period of time. For example, Best Caterers' income statement is dated "For the Month Ended September 30, 2008." It is prepared from the data appearing in the retained earnings column of Illustration 2-9. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

On the income statement, revenues are listed first, followed by expenses. Finally, net income (or net loss) is determined. Although practice varies, we have chosen in our illustrations and homework solutions to list expenses in order of magnitude. Alternative formats for the income statement will be considered in later chapters.

Note that investment and dividend transactions between the stockholders and the business are not included in the measurement of net income. For example, the cash dividend from Best Caterers, Inc., was not regarded as a business expense, as explained earlier. This type of transaction is considered a reduction of retained earnings, which causes a decrease in stockholders' equity. The result of the income statement, be it a loss or a profit, is then carried to the retained earnings statement (Illustration 2-10).

RETAINED EARNINGS STATEMENT

The retained earnings statement of Best Caterers, Inc., reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2008"). Data for the preparation of the retained earnings statement are obtained from the

Illustration 2-10

Financial statements and their interrelationships

BEST CATERERS, INC.		
Income Statement		
For the Month Ended September 30, 2008		
Revenues		
Service revenue		\$4,700
Expenses		
Salaries expense	\$900	
Rent expense	600	
Advertising expense	250	
Utilities expense	<u>200</u>	
Total expenses		<u>1,950</u>
Net income		<u><u>\$2,750</u></u>

BEST CATERERS, INC.		
Retained Earnings Statement		
For the Month Ended September 30, 2008		
Retained earnings, September 1		\$ 0
Add: Net income		<u>2,750</u>
		2,750
Less: Dividends		<u>1,300</u>
Retained earnings, September 30		<u><u>\$1,450</u></u>

BEST CATERERS, INC.		
Balance Sheet		
September 30, 2008		
<u>Assets</u>		
Cash		\$ 8,050
Accounts receivable		1,400
Supplies		1,600
Equipment		<u>7,000</u>
Total assets		<u><u>\$18,050</u></u>
<u>Liabilities and Stockholders' Equity</u>		
Liabilities		
Accounts payable		\$ 1,600
Stockholders' equity		
Common stock	\$15,000	
Retained earnings	<u>1,450</u>	<u>16,450</u>
Total liabilities and stockholders' equity		<u><u>\$18,050</u></u>

BEST CATERERS, INC.		
Statement of Cash Flows		
For the Month Ended September 30, 2008		
Cash flows from operating activities		
Cash receipts from revenues		\$ 3,300
Cash payments for expenses		<u>(1,950)</u>
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of common stock	\$15,000	
Payment of cash dividends	<u>(1,300)</u>	<u>13,700</u>
Net increase in cash		8,050
Cash at the beginning of the period		<u>0</u>
Cash at the end of the period		<u><u>\$ 8,050</u></u>

HELPFUL HINT

The heading of each statement identifies the company, the type of statement, and the specific date or time period covered by the statement.

HELPFUL HINT

The four financial statements are prepared in the sequence shown for the following reasons: Net income is computed first and is needed to determine the ending balance in retained earnings. The ending balance in retained earnings is needed in preparing the balance sheet. The cash shown on the balance sheet is needed in preparing the statement of cash flows.

HELPFUL HINT

Note that final sums are double-underlined, and negative amounts are presented in parentheses.

retained earnings column of the tabular summary (Illustration 2-9) and from the income statement in Illustration 2-10.

The beginning retained earnings amount is shown on the first line of the statement. Then net income and dividends are identified. The retained earnings ending balance is the final amount on the statement. The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement. The ending retained earnings is that amount carried to the balance sheet to reflect any changes in equity and to make the assets balance with the total liabilities and equity of the business (see Illustration 2-10).

BALANCE SHEET

Best Caterers, Inc.'s balance sheet (Illustration 2-10) reports the assets, liabilities, and stockholders' equity at a specific date (September 30, 2008). The balance sheet is prepared from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 2-9).

Observe that the assets are listed at the top, followed by liabilities and stockholders' equity. Total assets must equal total liabilities and stockholders' equity. In the Best Caterers illustration, only one liability, accounts payable, is reported on the balance sheet. In most cases there will be more than one liability. When two or more liabilities are involved, a customary way of listing is shown in Illustration 2-11.

Illustration 2-11

Presentation of liabilities

	<u>Liabilities</u>
Notes payable	\$10,000
Accounts payable	63,000
Salaries payable	<u>18,000</u>
Total liabilities	\$91,000

The balance sheet is like a snapshot of the company's financial condition at a specific moment in time (usually the month-end or year-end).

ACCOUNTING IN ACTION *Business Insight*



Why do companies choose the particular year-ends that they do? Not every company uses December 31 as the accounting year-end. Many companies choose to end their accounting year when inventory or operations are at a low. This is advantageous because compiling accounting information requires much time and effort by managers, so they would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low. Some companies whose year-ends differ from December 31 are **Delta Air Lines**, June 30; **Walt Disney Productions**, September 30; **Kmart Corp.**, January 31; and **Dunkin Donuts, Inc.**, October 31.

STATEMENT OF CASH FLOWS

The primary purpose of a statement of cash flows is to provide financial information about the cash receipts and cash payments of an enterprise for a specific period of time. **The statement of cash flows reports (1) the cash effects of a company's**

operations during a period, (2) its investing transactions, (3) its financing transactions, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period.

Reporting the sources, uses, and net increase or decrease in cash is useful because investors, creditors, and others want to know what is happening to a company's most liquid resource. The statement of cash flows, therefore, provides answers to the following simple but important questions:

1. Where did the cash come from during the period?
2. What was the cash used for during the period?
3. What was the change in the cash balance during the period?

A statement of cash flows for Best Caterers, Inc., is provided in Illustration 2-10.

As shown in the statement, cash increased \$8,050 during the period: Net cash flow provided from operating activities increased cash \$1,350. Cash flow from investing transactions decreased cash \$7,000. And cash flow from financing transactions increased cash \$13,700. At this time, you need not be concerned with how these amounts are determined. Appendix B will examine in detail how the statement is prepared.

HELPFUL HINT

Investing activities pertain to investments made by the company, not investments made by the stockholders.

HELPFUL HINT

The cash at the end of the period reported in the statement of cash flows equals the cash reported in the balance sheet.

BEFORE YOU GO ON...

▶ REVIEW IT

1. What are the income statement, retained earnings statement, balance sheet, and statement of cash flows?
2. How are the financial statements interrelated?

A LOOK BACK AT OUR FEATURE STORY

Refer back to the Feature Story about **PepsiCo** at the beginning of Chapter 1, and answer the following questions.

1. If you were interested in investing in **PepsiCo**, what would the balance sheet and income statement tell you?
2. Would you request audited financial statements? Explain.
3. Will the financial statements show the market value of the company? Explain.

SOLUTION

1. The balance sheet reports the assets, liabilities, and stockholders' equity of the company. The income statement presents the revenues and expenses and resulting net income (or net loss) for a specific period of time. The balance sheet is like a snapshot of the company's financial condition at a point in time. The income statement indicates the profitability of the company. Also, the sources of the company's revenues and its expenses are provided in the income statement.
2. You should request **audited** financial statements—statements that a CPA has examined and expressed an opinion as to the fairness of presentation. You should not make decisions without having audited financial statements.
3. The financial statements will not show the market value of the company. One important principle of accounting is the cost principle, which states that assets should be recorded at cost. Cost has an important advantage over other valuations: It is reliable.



A Look Back exercises refer to the chapter-opening Feature Story. These exercises help you to analyze that real-world situation in terms of the accounting topic of the chapter.

Demonstration Problems are a final review of the chapter. The **Action Plan** gives tips about how to approach the problem, and the **Solution** demonstrates both the form and the content of complete answers.

ACTION PLAN

- Remember that assets must equal liabilities plus stockholders' equity after each transaction.
- Investments and revenues increase stockholders' equity.
- Dividends and expenses decrease stockholders' equity.
- The income statement shows revenues and expenses for a period of time.
- The retained earnings statement shows the changes in retained earnings for a period of time.
- The balance sheet reports assets, liabilities, and stockholders' equity at a specific date.

DEMONSTRATION PROBLEM

Hospitality Legal Services, Inc., which provides contract services for caterers and their clients, was incorporated on July 1, 2008. During the first month of operations, the following transactions occurred:

- Stockholders invested \$10,000 in cash in exchange for shares of stock.
- Paid \$800 for July rent on office space.
- Purchased office equipment on account, \$3,000.
- Provided legal services to clients for cash, \$1,500 (use Service Revenue).
- Borrowed \$700 cash from a bank on a note payable.
- Performed legal services for client on account, \$2,000.
- Paid monthly expenses: salaries \$500; utilities \$300; and telephone \$100.

Instructions

- Prepare a tabular summary of the transactions.
- Prepare the income statement, retained earnings statement, and balance sheet at July 31 for Hospitality Legal Services, Inc.

SOLUTION TO DEMONSTRATION PROBLEM

(a) Trans- action	Assets			=	Liabilities		+	Stockholders' Equity	
	Cash	Accounts Receivable	Equipment	=	Notes Payable	Accounts Payable	+	Common Stock	Retained Earnings
(1)	+\$10,000							+\$10,000	
(2)	-800								-\$800 Rent Expense
	9,200			=				10,000 +	-800
(3)			+\$3,000			+\$3,000			
	9,200		+ 3,000	=		3,000		10,000 +	-800
(4)	+1,500								+1,500 Service Revenue
	10,700		+ 3,000	=		3,000		10,000 +	700
(5)	+700				+\$700				
	11,400		+ 3,000	=	700	3,000		10,000 +	700
(6)		+\$2,000							+2,000 Service Revenue
	+11,400	+ 2,000	+ 3,000	=	700	+ 3,000		10,000 +	2,700
(7)	-900								-500 Salaries Expense
									-300 Utilities Expense
									-100 Telephone Expense
	<u>\$10,500</u>	<u>+ 2,000</u>	<u>+ 3,000</u>	=	<u>700</u>	<u>+ 3,000</u>		<u>10,000</u>	<u>+ 1,800</u>
	\$15,500				\$15,500				

(b)

HOSPITALITY LEGAL SERVICES, INC. Income Statement For the Month Ended July 31, 2008

Revenues		
Service revenue		\$3,500
Expenses		
Rent expense	\$800	
Salaries expense	500	
Utilities expense	300	
Telephone expense	<u>100</u>	
Total expenses		<u>1,700</u>
Net income		<u>\$1,800</u>

HOSPITALITY LEGAL SERVICES, INC.
Retained Earnings Statement
For the Month Ended July 31, 2008

Retained earnings, July 1	\$ -0-
Add: Net income	<u>1,800</u>
Retained earnings, July 31	<u><u>\$1,800</u></u>

HOSPITALITY LEGAL SERVICES, INC.
Balance Sheet
July 31, 2008

Assets

Cash	\$10,500
Accounts receivable	2,000
Equipment	<u>3,000</u>
Total assets	<u><u>\$15,500</u></u>

Liabilities and Stockholders' Equity

Liabilities	
Notes payable	\$ 700
Accounts payable	<u>3,000</u>
Total liabilities	3,700
Stockholders' equity	
Common stock	\$10,000
Retained earnings	<u>1,800</u>
Total liabilities and stockholders' equity	<u><u>\$15,500</u></u>

This would be a good time to return to the **Student Owner's Manual** at the beginning of the book (or to look at it for the first time if you skipped it before) to read about the various types of assignment materials that appear at the end of each chapter. Knowing the purpose of the different assignments will help you appreciate what each contributes to your accounting skills and competencies.



BEFORE YOU GO ON...

► **REVIEW IT**

1. What is the major difference in the equity section of the balance sheet between a corporation and a proprietorship?
2. Where are income tax expense and earnings per share reported on the income statement? How is earnings per share computed?
3. How are the current ratio, working capital, profit margin percentage, return on assets, return on common stockholders' equity, and debt to total assets computed?
4. Explain how these ratios are useful in financial statement analysis.
5. What is the purpose of the International Accounting Standards Committee?
6. What are the three accounting guidelines publications for the hotel, restaurant, and club segments of the industry?
7. Identify and briefly explain the various positions available in an accounting department in a hotel operation.
8. Identify at least three areas in a club accounting operations which differ from that of a hotel operation.



ACTION PLAN**Remember that**

- The four principles are cost, revenue recognition, matching, and full disclosure.
- The two constraints are materiality and conservatism.
- Full disclosure relates generally to the item, materiality to the amount.

**ACTION PLAN**

- Remember that income tax expense is reported immediately after “Income before income taxes” for both a multiple-step and single-step income statement.
- Report earnings per share on both a multiple-step and a single-step income statement.
- Disclose net income and dividends on a retained earnings statement.
- Refer to Chapter 5, p. 159, for an example of a classified balance sheet.

DEMONSTRATION PROBLEM 1

Presented below are a number of operational guidelines and practices that have developed over time.

Instructions

Identify the accounting assumption, accounting principle, or reporting constraint that most appropriately justifies these procedures and practices. Use only one item per description.

- The first note, “Summary of Significant Accounting Policies,” presents information on the subclassification of plant assets and discusses the company’s depreciation methods.
- The local hamburger restaurant expenses all spatulas, french fry baskets, and other cooking utensils when purchased.
- Retailers recognize revenue at the point of sale.
- Green-Grow Landcape, Inc., includes an estimate of warranty expense in the year in which it sells its lawn mowers, which carry a 2-year warranty.
- Companies present sufficient financial information so that creditors and reasonably prudent investors will not be misled.
- Companies listed on U.S. stock exchanges report audited financial information annually and report unaudited information quarterly.
- Beach Resorts, Inc., does not record the 2004 value of \$1.5 million for a piece of beach-front property it purchased in 1989 for \$500,000.
- Restaurant Supplies, Inc., takes a \$32,000 loss on a number of older ovens in its inventory; it paid the manufacturer \$107,000 for them but can sell them for only \$75,000.
- Frito Lay** is a wholly owned subsidiary of **PepsiCo, Inc.**, and Frito Lay’s operating results and financial condition are included in the consolidated financial statements of PepsiCo. (Do not use full disclosure.)

SOLUTION TO DEMONSTRATION PROBLEM 1

- | | |
|-----------------------------------|--------------------------------|
| (a) Full disclosure principle | (f) Time period assumption |
| (b) Materiality constraint | (g) Cost principle |
| (c) Revenue recognition principle | (h) Conservatism constraint |
| (d) Matching principle | (i) Economic entity assumption |
| (e) Full disclosure principle | |

DEMONSTRATION PROBLEM 2

Presented below is financial information related to Notting Hill Hotel Corporation for the year 2008. All balances are ending balances unless stated otherwise.

Accounts payable	\$ 868,000
Accounts receivable	700,000
Accumulated depreciation—equipment	100,000
Administrative expenses	280,000
Bonds payable	1,600,000
Cash	800,000
Common stock	500,000
Cost of goods sold	1,600,000
Dividends	60,000
Equipment	1,100,000
Income tax expense	83,000
Interest expense	60,000
Interest revenue	120,000
Inventories	500,000

Loss on the sale of equipment	35,000
Marketable (trading) securities	400,000
Net sales	2,400,000
Notes payable (short-term)	800,000
Other long-term debt	387,000
Patents and other intangibles	900,000
Prepaid expenses	200,000
Retained earnings (January 1, 2008)	80,000
Selling expenses	220,000
Taxes payable	83,000

Notting Hill Hotel Corporation had 88,000 shares of common stock outstanding for the entire year.

Instructions

- (a) Prepare a multiple-step income statement.
- (b) Prepare a single-step income statement.
- (c) Prepare a retained earnings statement.
- (d) Prepare a classified balance sheet.

SOLUTION TO DEMONSTRATION PROBLEM 2

- (a) Multiple-step income statement

NOTTING HILL HOTEL CORPORATION
Income Statement
For the Year Ended December 31, 2008

Net sales		\$2,400,000
Cost of goods sold		<u>1,600,000</u>
Gross profit		800,000
Selling expenses	\$220,000	
Administrative expenses	<u>280,000</u>	<u>500,000</u>
Income from operations		300,000
Other revenues and gains		
Interest revenue		120,000
Other expenses and losses		
Loss on sale of equipment	35,000	
Interest expense	<u>60,000</u>	<u>95,000</u>
Income before income taxes		325,000
Income tax expense		<u>83,000</u>
Net income		<u>\$ 242,000</u>
Earnings per share		<u>\$2.75</u>

- (b) Single-step income statement

NOTTING HILL HOTEL CORPORATION
Income Statement
For the Year Ended December 31, 2008

Revenues		
Net sales		\$2,400,000
Interest revenue		<u>120,000</u>
Total revenues		2,520,000

(continues)

Expenses		
Cost of goods sold	\$1,600,000	
Selling expenses	220,000	
Administrative expenses	280,000	
Interest expense	60,000	
Loss on the sale of equipment	<u>35,000</u>	2,195,000
Income before income taxes		325,000
Income tax expense		<u>83,000</u>
Net income		<u>\$ 242,000</u>
Earnings per share		<u>\$2.75</u>

(c) Retained earnings statement

NOTTING HILL HOTEL CORPORATION
Retained Earnings Statement
For the Year Ended December 31, 2008

Retained earnings, January 1	\$ 80,000
Add: Net income	<u>242,000</u>
	322,000
Less: Dividends	<u>60,000</u>
Retained earnings, December 31	<u>\$262,000</u>

(d) Classified balance sheet

NOTTING HILL HOTEL CORPORATION
Balance Sheet
December 31, 2008

Current assets		
Cash		\$ 800,000
Marketable (trading) securities		400,000
Accounts receivable		700,000
Inventories		500,000
Prepaid expenses		<u>200,000</u>
Total current assets		2,600,000
Property, plant, and equipment		
Equipment	\$1,100,000	
Less: Accumulated depreciation	<u>100,000</u>	1,000,000
Intangible assets		
Patents and other intangible assets		<u>900,000</u>
Total assets		<u>\$4,500,000</u>
Current liabilities		
Notes payable		\$ 800,000
Accounts payable		868,000
Taxes payable		<u>83,000</u>
Total current liabilities		1,751,000
Long-term liabilities		
Bonds payable	\$1,600,000	
Other long-term debt	<u>387,000</u>	1,987,000
Total liabilities		3,738,000
Stockholders' equity		
Common stock	500,000	
Retained earnings	<u>262,000</u>	762,000
Total liabilities and stockholders' equity		<u>\$4,500,000</u>

SUMMARY OF STUDY OBJECTIVES

1. Explain the meaning of generally accepted accounting principles and identify the key items of the conceptual framework.

Generally accepted accounting principles are a set of rules and practices that are recognized as a general guide for financial reporting purposes. Generally accepted means that these principles must have “substantial authoritative support.” The key items of the conceptual framework are: (1) objectives of financial reporting; (2) qualitative characteristics of accounting information; (3) elements of financial statements; and (4) operating guidelines (assumptions, principles, and constraints).

2. Describe the basic objectives of financial reporting. The basic objectives of financial reporting are to provide information that is (1) useful to those making investment and credit decisions; (2) helpful in assessing future cash flows; and (3) helpful in identifying economic resources (assets), the claims to those resources (liabilities), and the changes in those resources and claims.

3. Discuss the qualitative characteristics of accounting information and elements of financial statements. To be judged useful, information should possess the following qualitative characteristics: relevance, reliability, comparability, and consistency. The elements of financial statements are a set of definitions that can be used to describe the basic terms used in accounting.

4. Identify the basic assumptions used by accountants. The major assumptions are: monetary unit, economic entity, time period, and going concern.

5. Identify the basic principles of accounting. The major principles are revenue recognition, matching, full disclosure, and cost.

6. Identify the two constraints in accounting. The major constraints are materiality and conservatism.

7. Explain the accounting principles used in international operations. There are few recognized worldwide accounting standards. The International Accounting Standards Committee (IASC), of which the United States is a member, is working to obtain conformity in international accounting practices.

8. Analyze the effects of business transactions on the basic accounting equation. Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset is increased, there must be a corresponding (1) decrease in another asset, or (2) increase in a specific liability, or (3) increase in stockholders’ equity.

9. Understand what the four financial statements are and how they are prepared. An income statement presents the revenues and expenses of a company for a specified period of time. A retained earnings statement summarizes the changes in retained earnings that have occurred for a specific period of time. A balance sheet reports the assets, liabilities, and stockholders’ equity of a business at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

GLOSSARY

Balance sheet A financial statement that reports the assets, liabilities, and stockholders’ equity at a specific date (p. 52).

Comparability Ability to compare accounting information of different companies because they use the same accounting principles (p. 34).

Conceptual framework A coherent system of interrelated objectives and fundamentals that can lead to consistent standards (p. 33).

Conservatism The approach of choosing an accounting method when in doubt that will least likely overstate assets and net income (p. 42).

Consistency Use of the same accounting principles and methods from year to year within a company (p. 35).

Cost principle Accounting principle that assets should be recorded at their historical cost (p. 40).

Economic entity assumption Accounting assumption that economic events can be identified with a particular unit of accountability (p. 37).

Elements of financial statements Definitions of basic terms used in accounting (p. 35).

Full disclosure principle Accounting principle that circumstances and events that make a difference to financial statement users should be disclosed (p. 40).

Generally accepted accounting principles (GAAP) A set of rules and practices, having substantial authoritative support, that are recognized as a general guide for financial reporting purposes (p. 32).

Going concern assumption The assumption that the enterprise will continue in operation long enough to carry out its existing objectives and commitments (p. 37).

Income statement A financial statement that presents the revenues and expenses and resulting net income or net loss of a company for a specific period of time (p. 52).

International Accounting Standards Committee (IASC) An accounting organization whose purpose is to formulate and publish international accounting standards and to promote their acceptance worldwide (p. 44).

Matching principle Accounting principle that expenses should be matched with revenues in the period when efforts are expended to generate revenues (p. 38).

Materiality The constraint of determining if an item is important enough to likely influence the decision of a reasonably prudent investor or creditor (p. 42).

Monetary unit assumption Accounting assumption that only transaction data capable of being expressed in monetary terms should be included in accounting records (p. 37).

Relevance The quality of information that indicates the information makes a difference in a decision (p. 34).

Reliability The quality of information that gives assurance that it is free of error and bias (p. 34).

Retained earnings statement A financial statement that summarizes the changes in retained earnings for a specific period of time (p. 52).

Revenue recognition principle Accounting principle that revenue should be recognized in the accounting period in which it is earned (generally at the point of sale) (p. 38).

Statement of cash flows A financial statement that provides information about the cash inflows (receipts) and cash outflows (payments) of an entity for a specific period of time (p. 52).

Time period assumption Accounting assumption that the economic life of a business can be divided into artificial time periods (p. 37).

Transactions The economic events of the enterprise that are recorded by accountants (p. 44).

EXERCISES

Identify generally accepted accounting principles.
(SO 1)

2-1 Indicate whether each of the following statements is true (T) or false (F).

- _____ GAAP stands for generally accepted accounting practices.
- _____ FASB stands for Financial Accounting Standards Board.
- _____ Together with the Securities and Exchange Commission, the GAAP set guidelines for how the FASB should operate.

Identify items included in conceptual framework.
(SO 1)

2-2 Which of the following is (Yes) or is not (No) part of the FASB conceptual framework?

- _____ Objectives of managerial reporting
- _____ Elements of financial statements
- _____ Quantitative characteristics of accounting information

Identify objectives of financial reporting.
(SO 2)

2-3 Which of the following is (Yes) or is not (No) a part of the three objectives of financial reporting under FASB?

- _____ The information is useful to the employees only.
- _____ The managerial forms are helpful in assessing current cash flows.
- _____ The economic resources, the claims to those resources, and the changes in those resources and claims are clearly identified.

(SO 3)

2-4 Presented below are four concepts. Please match each one with the correct scenario.

Relevance Reliability Comparability Consistency

- _____ Hotel Del Sol uses the Uniform System of Accounts so that it can assess how it is performing financially against like hotels.
- _____ Hotel Del Sol uses the straight line method for its depreciation and is expected to use this method in the succeeding years.
- _____ The controller at Hotel Del Sol provides information that is timely and has feedback and predictive value.
- _____ The controller and her staff at Hotel Del Sol check their work to make sure it is accurate.

(SO 3)

2-5 The operating guidelines of accounting have three parts: assumptions, principles, and constraints. Please match these guidelines with the following by indicating "A" for assumptions, "P" for principles, and "C" for constraints.

- _____ Going concern
- _____ Time period
- _____ Materiality
- _____ Revenue recognition
- _____ Conservatism
- _____ Matching

2-6 Presented below are six business transactions. On a sheet of paper, list the letters (a), (b), (c) with columns for assets, liabilities, and stockholders' equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and stockholders' equity.

- (a) Purchased food on account.
- (b) Received cash for providing catering service.
- (c) Billed customer for \$5,000 on hotel room sold.
- (d) Paid \$150 for electricity bill.
- (e) Invested \$50,000 in the business.
- (f) Paid \$300 for lawn services for the motel.

Determine effect of transactions on basic accounting equation.
(SO 8)

2-7 Selected transactions for Golden Apples Catering Company are listed below.

1. Made cash investment to start business.
2. Paid monthly electricity bill.
3. Purchased food on account.
4. Received cash from customers.
5. Paid dividends.
6. Paid weekly wages.
7. Paid for food purchased in transaction (3).
8. Purchased additional kitchen equipment on account.
9. Paid rent for the month.

Analyze the effect of transactions.
(SO 8)

Instructions

List the numbers of the preceding transactions and describe the effect of each transaction on assets, liabilities, and stockholders' equity. For example, the first answer is: (1) Increase in assets and increase in stockholders' equity.

2-8 W. S. Blaskowski Foodservices entered into the following transactions during May 2008.

1. Purchased kitchen equipment for \$30,000 from General Appliances on account.
2. Paid \$3,000 cash for May rent.
3. Received \$5,000 cash from customers for services billed in April.
4. Provided services to the Osbornes' 50th wedding anniversary.
5. Paid World Web Services \$5,000 cash for advertising in May.
6. Stockholders invested an additional \$50,000 in the business.
7. Paid General Appliances for the equipment purchased in transaction (1).
8. Incurred consulting expense for May of \$2,000 on account.

Analyze the effect of transactions on assets, liabilities, and stockholders' equity.
(SO 8)

Instructions

Indicate with the appropriate letter whether each of the preceding transactions results in

- (a) an increase in assets and a decrease in assets.
- (b) an increase in assets and an increase in stockholders' equity.
- (c) an increase in assets and an increase in liabilities.
- (d) a decrease in assets and a decrease in stockholders' equity.
- (e) a decrease in assets and a decrease in liabilities.
- (f) an increase in liabilities and a decrease in stockholders' equity.
- (g) an increase in stockholders' equity and a decrease in liabilities.

2-9 On June 1, Maui Travel Agency, Inc., was established. The following transactions were completed during the month.

1. Stockholders invested \$40,000 cash, receiving common stock in exchange.
2. Paid \$1,000 cash for June office rent.
3. Purchased office equipment for \$5,000 cash.
4. Paid \$1,000 cash for office supplies.
5. Incurred \$500 of advertising costs in the *Daily Maui*, on account.
6. Earned \$25,000 for services rendered: Cash of \$12,000 is received from customers, and the balance of \$13,000 is billed to customers on account.
7. Paid \$750 cash dividend.
8. Paid *Daily Maui* amount due in transaction (4).
9. Paid employees' salaries \$2,500.
10. Cash of \$10,000 is received from customers who have previously been billed in transaction (6).

Analyze transactions and compute net income.
(SO 8)

Analyze transactions and prepare income statement, balance sheet, and retained earnings statement.
(SO 8)

Instructions

- (a) Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Office Equipment, Accounts Payable, Common Stock, and Retained Earnings.
- (b) From an analysis of the Retained Earnings column, compute the net income or net loss for June.

2-10 Kiki's Famous Desserts Corporation was formed on July 1, 2007. On July 31, the balance sheet showed Cash \$7,000, Accounts Receivable \$2,000, Supplies \$500, Office Equipment \$5,000, Accounts Payable \$5,500, Common Stock \$7,500, and Retained Earnings \$1,500. During August, the following transactions occurred.

1. Collected \$1,000 of accounts receivable.
2. Paid \$1,200 cash on accounts payable.
3. Earned revenues of \$10,000, of which \$3,000 is collected in cash and the balance is due in September.
4. Purchased additional office equipment for \$2,000, paying \$250 in cash and the balance on account.
5. Paid salaries \$2,000, rent for August \$1,500, and advertising expenses \$450.
6. Paid dividends of \$550.
7. Received \$1,000 from Allied Bank—money borrowed on a note payable.
8. Incurred utility expenses for month on account \$500.

Instructions

- (a) Prepare a tabular analysis of the August transactions beginning with July 31 balances. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Office Equipment = Notes Payable + Accounts Payable + Common Stock + Retained Earnings.
- (b) Prepare an income statement for August, a retained earnings statement for August, and a balance sheet at August 31.

EXPLORING THE WEB

2-11 The **Financial Accounting Standards Board (FASB)** is a private organization established to improve accounting standards and financial reporting. The FASB conducts extensive research before issuing a "Statement of Financial Accounting Standards," which represents an authoritative expression of generally accepted accounting principles.

Address: www.accounting.rutgers.edu/raw

Steps:

1. Choose **FASB**.
2. Choose **FASB Facts**.

Instructions

Answer the following questions.

- (a) What is the mission of the FASB?
- (b) How are topics added to the FASB technical agenda?
- (c) What characteristics make the FASB's procedures an "open" decision-making process?

ETHICS CASE

2-12 When the Financial Accounting Standards Board issues new standards, the required implementation date is usually 12 months or more from the date of issuance, with early implementation encouraged. Richard Keith, accountant at Manchester Corporation, discusses with his financial vice president the need for early implementation of a recently issued standard that would result in a much fairer presentation of the company's financial condition and earnings. When the financial vice president determines that early implementation of the standard will adversely affect reported net income for the year, he strongly discourages Richard from implementing the standard until it is required.

Instructions

- (a) Who are the stakeholders in this situation?
- (b) What, if any, are the ethical considerations in this situation?
- (c) What does Richard have to gain by advocating early implementation? Who might be affected by the decision against early implementation?



Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.