1 Accounting Concepts and Procedures

MARTHA STEWART LIVING OMNIMEDIA, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
For the Years Ended December 31, 2003, 2002, and 2001
(in thousands except per share data)

	2003	2002	2001
REVENUES			
Publishing	$135,936	$182,600	$177,422
Television	25,704	26,680	29,522
Merchandising	53,395	48,896	35,572
Internet/Direct Commerce	30,813	36,873	46,094
Total Revenues	$245,848	$295,049	$288,610

Tip on Reading a Financial Report*

Revenues do not mean cash. Revenues are not assets. They create inward flows of cash or accounts receivable. The total revenues of $245,848,000 listed for Martha Stewart Living do not consist of cash only.
***You will understand this tip more clearly after reading the chapter.**

Learning Objectives

- Defining and listing the functions of accounting. (p. 5)
- Recording transactions in the basic accounting equation. (p. 7)
- Seeing how revenue, expenses, and withdrawals expand the basic accounting equation. (p. 12)
- Preparing an income statement, a statement of owner's equity, and a balance sheet. (p. 17)

In the past few years you could pick up almost any newspaper and see headlines of financial scandals. Enron and WorldCom are good examples. Were these companies "cooking the books"? In 2002 a federal statute called the Sarbanes-Oxley Act was passed to prevent fraud at public companies. This act requires a closer look at the internal controls and the accuracy of the financial results of a company.

Accounting is the language of business; it provides information to managers, owners, investors, governmental agencies, and others inside and outside the organization. Accounting provides answers and insights to questions like these:

- Should I invest in Home Depot or Wal-Mart stock?
- Will JetBlue show good returns in the future?
- Can United Airlines pay its debt obligations?
- What percentage of Ford's marketing budget is allocated to e-business? How does that percentage compare with the competition? What is the overall financial condition of Ford?

Smaller businesses also need answers to their financial questions:

- At a local Walgreens, did business increase enough over the last year to warrant hiring a new assistant?
- Should Local Auto Detailing Co. spend more money to design, produce, and send out new brochures in an effort to create more business?
- What role should the Internet play in the future of business spending?

Accounting is as important to individuals as it is to businesses; it answers questions like these:

- Should I take out a loan to buy a new Ford Explorer or wait until I can afford to pay cash for it?
- Would my money work better in a money market or in the stock market?

The accounting process analyzes, records, classifies, summarizes, reports, and interprets financial information for decision makers—whether individuals, small businesses, large corporations, or governmental agencies—in a timely fashion. It is important that students understand the "whys" of this accounting process. Just knowing the mechanics is not enough.

The three main categories of business organization are (1) sole proprietorships, (2) partnerships, and (3) corporations. Let's define each of them and look at their advantages and disadvantages. This information also appears in Table 1.1.

SOLE PROPRIETORSHIP A **sole proprietorship,** such as Lee's Nail Care, is a business that has one owner. That person is both the owner and the manager of the business. An advantage of a sole proprietorship is that the owner makes all the decisions for the business. A disadvantage is that if the business cannot pay its obligations, the business owner must pay them, which means that the owner could lose some of his or her personal assets (e.g., house or savings).

Sole proprietorships are easy to form. They end if the business closes or when the owner dies.

PARTNERSHIP A **partnership,** such as Miller and Kaminsky, is a form of business ownership that has at least two owners (partners). Each partner acts as an owner of the company, which is an advantage because the partners can share the decision making and the risks of the business. A disadvantage is that, as in a sole proprietorship, the partners' personal assets could be lost if the partnership cannot meet its obligations.

Partnerships are easy to form. They end when a partner dies or leaves the partnership, or when the partners decide to close the business.

CORPORATION A **corporation,** such as Kellogg Company, is a business owned by stockholders. The corporation may have only a few stockholders, or it may have many stock-

TABLE 1.1 Types of Business Organizations

	Sole Proprietorship (Lee's Nail Care)	Partnership (Miller and Kaminsky)	Corporation (Kellogg Company)
Ownership	Business owned by one person.	Business owned by more than one person.	Business owned by stockholders.
Formation	Easy to form.	Easy to form.	More difficult to form.
Liability	Owner could lose personal assets to meet obligations of business.	Partners could lose personal assets to meet obligations of partnership.	Limited personal risk. Stockholders' loss is limited to their investment in the company.
Closing	Ends with death of owner or closing of business.	Ends with death of partner, or closing of business.	Can continue indefinitely.

holders. The stockholders are not personally liable for the corporation's debts, and they usually do not have input into the business decisions.

Corporations are more difficult to form than sole proprietorships or partnerships. Corporations can exist indefinitely.

Many corporate executives feel that Sarbanes-Oxley is too strict and results in too high of a cost to implement.

Classifying Business Organizations

Whether we are looking at a sole proprietorship, a partnership, or a corporation, the business can be classified by what the business does to earn money. Companies are categorized as service, merchandise, or manufacturing businesses.

A limo service is a good example of a **service company** because it provides a service. The first part of this book focuses on service businesses.

Old Navy and J.C. Penney sell products. They are called merchandise companies. **Merchandise companies** can either make their own products or sell products that are made by another supplier. Companies such as Intel and Ford Motor Company that make their own products are called **manufacturers.** (See Table 1.2.)

Definition of Accounting

Accounting (also called the accounting process) is a system that measures the activities of a business in financial terms. It provides various reports and financial statements that show how the various transactions the business undertook (e.g., buying and selling goods) affected the business. This accounting process performs the following functions:

- **Analyzing:** Looking at what happened and how the business was affected.
- **Recording:** Putting the information into the accounting system.
- **Classifying:** Grouping all the same activities (e.g., all purchases) together.
- **Summarizing:** Totaling the results.
- **Reporting:** Issuing the statements that tell the results of the previous functions.

TABLE 1.2 Examples of Service, Merchandise, and Manufacturing Businesses

Service Businesses	Merchandise Businesses	Manufacturing Businesses
Lee's Nail Care	Polo	Budweiser
eBay	J.C. Penney	Ford
Dr. Wheeler, M.D.	Amazon.com	Toro
Accountemps	Home Depot	Levi's
Langley Landscaping	Old Navy	Intel

- **Interpreting:** Examining the statements to determine how the various pieces of information they contain relate to each other.
- **Communication:** Providing the reports and financial statements to people who are interested in the information, such as the business's decision makers, investors, creditors, and governmental agencies (e.g., the Internal Revenue Service).

Appendix A will look at the annual report of Kellogg Company.

As you can see, a lot of people use these reports. A set of procedures and guidelines were developed to make sure that everyone prepares and interprets them the same way. These guidelines are known as **generally accepted accounting principles (GAAP).**

Now let's look at the difference between bookkeeping and accounting. Keep in mind that we use the terms *accounting* and the *accounting process* interchangeably.

Difference Between Bookkeeping and Accounting

In the May 2, 2005, issue of *The Wall Street Journal,* American International Group (AIG) reported that it would have to fix four years of financial statements due to improperly recording certain transactions. Confusion often arises concerning the difference between bookkeeping and accounting. **Bookkeeping** is the recording (recordkeeping) function of the accounting process; a bookkeeper enters accounting information in the company's books. An accountant takes that information and prepares the financial statements that are used to analyze the company's financial position. Accounting involves many complex activities. Often, it includes the preparation of tax and financial reports, budgeting, and analyses of financial information.

Today, computers are used for routine bookkeeping operations that used to take weeks or months to complete. The text explains how the advantages of the computer can be applied to a manual accounting system by using hands-on knowledge of how accounting works. Basic accounting knowledge is needed even though computers can do routine tasks. QuickBooks, Excel, and Peachtree are popular software packages in use today.

Learning Unit 1-1 The Accounting Equation

Assets, Liabilities, and Equities

Let's begin our study of accounting concepts and procedures by looking at a small business: Mia Wong's law practice. Mia decided to open her practice at the end of August. She consulted her accountant before she made her decision. The accountant told her some important things before she made this decision. First, he told her the new business would be considered a separate business entity whose finances had to be kept separate and distinct from Mia's personal finances. The accountant went on to say that all transactions can be analyzed using the basic accounting equation: Assets = Liabilities + Owner's Equity.

Mia had never heard of the basic accounting equation. She listened carefully as the accountant explained the terms used in the equation and how the equation works.

Assets Cash, land, supplies, office equipment, buildings, and other properties of value *owned* by a firm are called **assets.**

Equities The rights of financial claim to the assets are called **equities.** Equities belong to those who supply the assets. If you are the only person to supply assets to the firm, you have the sole rights or financial claims to them. For example, if you supply the law firm with \$6,000 in cash and \$8,000 in office equipment, your equity in the firm is \$14,000.

Relationship Between Assets and Equities The relationship between assets and equities is

Assets = Equities
(Total value of items *owned* by business) (Total claims against the assets)

The total dollar value of the assets of your law firm will be equal to the total dollar value of the financial claims to those assets, that is, equal to the total dollar value of the equities.

The total dollar value is broken down on the left-hand side of the equation to show the specific items of value owned by the business and on the right-hand side to show the types of claims against the assets owned.

Liabilities A firm may have to borrow money to buy more assets; when it does, it means the firm *buys assets on account* (buy now, pay later). Suppose the law firm purchases a new computer for $3,000 on account from Dell, and the company is willing to wait 10 days for payment. The law firm has created a **liability:** an obligation to pay that comes due in the future. Dell is called the **creditor.** This liability—the amount owed to Dell—gives the store the right, or the financial claim, to $3,000 of the law firm's assets. When Dell is paid, the store's rights to the assets of the law firm will end, because the obligation has been paid off.

Basic Accounting Equation To best understand the various claims to a business's assets, accountants divide equities into two parts. The claims of creditors—outside persons or businesses—are labeled *liabilities.* The claim of the business's owner is labeled **owner's equity.** Let's see how the accounting equation looks now.

Assets − Liabilities = Owner's Equity

Assets = **Equities**

1. Liabilities: rights of creditors
2. Owner's equity: rights of owner

Assets = Liabilities + Owner's Equity

The total value of all the assets of a firm equals the combined total value of the financial claims of the creditors (liabilities) and the claims of the owners (owner's equity). This calculation is known as the **basic accounting equation.** The basic accounting equation provides a basis for understanding the conventional accounting system of a business. The equation records business transactions in a logical and orderly way that shows their impact on the company's assets, liabilities, and owner's equity.

Importance of Creditors Another way of presenting the basic accounting equation is

Assets – Liabilities = Owner's Equity

This form of the equation stresses the importance of creditors. The owner's rights to the business's assets are determined after the rights of the creditors are subtracted. In other words, creditors have first claim to assets. If a firm has no liabilities—and therefore no creditors—the owner has the total rights to assets. Another term for the owner's current investment, or equity, in the business's assets is **capital.**

In accounting, capital does not mean cash. Capital is the owner's current investment, or equity, in the assets of the business.

As Mia Wong's law firm engages in business transactions (paying bills, serving customers, and so on), changes will take place in the assets, liabilities, and owner's equity (capital). Let's analyze some of these transactions.

Transaction A Aug. 28: Mia invests $6,000 in cash and $200 of office equipment into the business.

On August 28, Mia withdraws $6,000 from her personal bank account and deposits the money in the law firm's newly opened bank account. She also invests $200 of office equipment in the business. She plans to be open for business on September 1. With the help of her accountant, Mia begins to prepare the accounting records for the business. We put this information into the basic accounting equation as follows:

Assets			= Liabilities +	Owner's Equity
Cash	+	Office Equipment	=	Mia Wong, Capital
$6,000	+	$200	=	$6,200

$6,200 = $6,200

Note that the total value of the assets, cash, and office equipment—$6,200—is equal to the combined total value of liabilities (none, so far) and owner's equity ($6,200). Remember, Wong has supplied all the cash and office equipment, so she has the sole financial claim to the assets. Note how the heading "Mia Wong, Capital" is written under the owner's equity heading. The $6,200 is Mia's investment, or equity, in the firm's assets.

Transaction B Aug. 29: Law practice buys office equipment for cash, $500.

From the initial investment of $6,000 cash, the law firm buys $500 worth of office equipment (such as a computer desk), which lasts a long time, whereas **supplies** (such as pens) tend to be used up relatively quickly.

	Assets			= Liabilities +	Owner's Equity
	Cash	+	Office Equipment	=	Mia Wong, Capital
BEGINNING BALANCE	$6,000	+	$200	=	$6,200
TRANSACTION	−500		+500		
ENDING BALANCE	$5,500	+	$700	=	$6,200

$6,200 = $6,200

Shift in Assets As a result of the last transaction, the law office has less cash but has increased its amount of office equipment. This **shift in assets** indicates that the makeup of the assets has changed, but the total of the assets remains the same.

Suppose you go food shopping at Wal-Mart with $100 and spend $60. Now you have two assets, food and money. The composition of the assets has *shifted*—you have more food and less money than you did—but the *total* of the assets has not increased or decreased. The total value of the food, $60, plus the cash, $40, is still $100. When you borrow money from the bank, on the other hand, you increase cash (an asset) and increase liabilities at the same time. This action results in an increase in assets, not just a shift.

An accounting equation can remain in balance even if only one side is updated. The key point to remember is that the left-hand-side total of assets must always equal the right-hand-side total of liabilities and owner's equity.

Transaction C Aug. 30: Buys additional office equipment on account, $300.

The law firm purchases an additional $300 worth of chairs and desks from Wilmington Company. Instead of demanding cash right away, Wilmington agrees to deliver the equipment and to allow up to 60 days for the law practice to pay the invoice (bill).

This liability, or obligation to pay in the future, has some interesting effects on the basic accounting equation. Wilmington Company accepts as payment a partial claim against the assets of the law practice. This claim exists until the law firm pays off the bill. This unwritten promise to pay the creditor is a liability called **accounts payable.**

	Assets			=	Liabilities	+	Owner's Equity
	Cash	+	Office Equipment	=	Accounts Payable	+	Mia Wong, Capital
BEGINNING BALANCE	$5,500	+	$700	=			$6,200
TRANSACTION			+300		+$300		
ENDING BALANCE	$5,500	+	$1,000	=	$300	+	$6,200

$6,500 = $6,500

When this information is analyzed, we can see that the law practice increased what it owes (accounts payable) as well as what it owns (office equipment) by $300. The law practice gains $300 in an asset but also takes on an obligation to pay Wilmington Company at a future date.

The owner's equity remains unchanged. This transaction results in an increase of total assets from $6,200 to $6,500.

Finally, note that after each transaction the basic accounting equation remains in balance.

Learning Unit 1-1 Review

AT THIS POINT you should be able to

- Define and explain the purpose of the Sarbanes-Oxley Act. (p. 4)
- Define and explain the differences between sole proprietorships, partnerships, and corporations. (p. 4)
- List the functions of accounting. (p. 5)
- Compare and contrast bookkeeping and accounting. (p. 6)
- Explain the role of the computer as an accounting tool. (p. 6)
- State the purpose of the accounting equation. (p. 6)
- Explain the difference between liabilities and owner's equity. (p. 7)
- Define capital. (p. 7)
- Explain the difference between a shift in assets and an increase in assets. (p. 8)

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To test your understanding of this material, complete Self-Review Quiz 1-1. The blank forms you need are in the *Study Guide and Working Papers* for Chapter 1. The solution to the quiz immediately follows here in the text. If you have difficulty doing the problems, review Learning Unit 1-1 and the solution to the quiz. Be sure to check the Slater Web site for student study aids.

Keep in mind that learning accounting is like learning to type: The more you practice, the better you become. You will not be an expert in one day. Be patient. It will all come together.

Self-Review Quiz 1-1

(The blank forms you need are on page 1 of the *Study Guide and Working Papers*.)

Record the following transactions in the basic accounting equation:

1. Gracie Ryan invests $17,000 to begin a real estate office.
2. The real estate office buys $600 of computer equipment from Wal-Mart for cash.
3. The real estate company buys $800 of additional computer equipment on account from Circuit City.

QUIZ TIP:
Note that transaction 2 is a shift in assets, whereas transaction 3 is an increase in assets. Keep asking yourself, What did the business get and who supplied it to the business? Remember, capital is not cash. Cash is an asset, whereas capital is part of owner's equity.

Solution to Self-Review Quiz 1-1

Assets			=	Liabilities	+	Owner's Equity	
Cash	+	Computer Equipment	=	Accounts Payable	+	Gracie Ryan, Capital	
+$17,000						+$17,000	
17,000			=			17,000	**1. BALANCE**
−600		+$600					
16,400	+	600	=			17,000	**2. BALANCE**
		+800		+$800			
$16,400	+	$1,400	=	$800	+	$17,000	**3. ENDING BALANCE**

$17,800 = $17,800

Learning Unit 1-2 The Balance Sheet

> The balance sheet shows the company's financial position as of a particular date. (In our example, that date is at the end of August.)

In the first learning unit, the transactions for Mia Wong's law firm were recorded in the accounting equation. The transactions we recorded occurred before the law firm opened for business. A statement called a **balance sheet** or **statement of financial position** can show the history of a company before it opened. The balance sheet is a formal statement that presents the information from the ending balances of both sides of the accounting equation. Think of the balance sheet as a snapshot of the business's financial position as of a particular date.

Let's look at the balance sheet of Mia Wong's law practice for August 31, 200X, shown in Figure 1.1. The figures in the balance sheet come from the ending balances of the accounting equation for the law practice as shown in Learning Unit 1-1.

Note in Figure 1.1 that the assets owned by the law practice appear on the left-hand side and that the liabilities and owner's equity appear on the right-hand side. Both sides equal $6,500. This *balance* between left and right gives the balance sheet its name. In later chapters we look at other ways to set up a balance sheet.

Points to Remember in Preparing a Balance Sheet

The Heading The heading of the balance sheet provides the following information:

- The company name: Mia Wong, Attorney-at-Law.
- The name of the statement: Balance Sheet.
- The date for which the report is prepared: August 31, 200X.

Use of the Dollar Sign Note that the dollar sign is not repeated each time a figure appears. As shown in Figure 1.2, the balance sheet for Mia Wong's law practice, it usually is placed to the left of each column's top figure and to the left of the column's total.

> The three elements that make up a balance sheet are assets, liabilities, and owner's equity.

Distinguishing the Total When adding numbers down a column, use a single line before the total and a double line beneath it. A single line means that the numbers above it have been added or subtracted. A double line indicates a total. It is important to align the numbers in the column; many errors occur because these figures are not lined up. These rules are the same for all accounting reports.

The balance sheet gives Mia the information she needs to see the law firm's financial position before it opens for business. This information does not tell her, however, whether the firm will make a profit.

FIGURE 1.1

The Balance Sheet

	ASSETS		=	LIABILITIES	+	OWNER'S EQUITY
	Cash	+ Office Equipment	=	Accounts Payable	+	Mia Wong, Capital
ENDING BALANCES	$5,500	+ $1,000	=	$300	+	$6,200

MIA WONG, ATTORNEY-AT-LAW
BALANCE SHEET
AUGUST 31, 200X

Assets		Liabilities and Owner's Equity	
Cash	$ 5500 00	Liabilities	
Office Equipment	1000 00	Accounts Payable	$ 300 00
		Owner's Equity	
		Mia Wong, Capital	6200 00
		Total Liabilities and	
Total Assets	$ 6500 00	Owner's Equity	$ 6500 00

FIGURE 1.2

Partial Balance Sheet

MIA WONG, ATTORNEY-AT-LAW
BALANCE SHEET
AUGUST 31, 200X

Assets	
Cash	$ 5500 00
Office Equipment	1000 00
Total Assets	$ 6500 00

A single line means the numbers above it have been added or subtracted.

A double line indicates a total.

Learning Unit 1-2 Review

AT THIS POINT you should be able to

- Define and state the purpose of a balance sheet. (p. 10)
- Identify and define the elements making up a balance sheet. (p. 10)
- Show the relationship between the accounting equation and the balance sheet. (p. 10)
- Prepare a balance sheet in proper form from information provided. (p. 10)

Self-Review Quiz 1-2

(The blank forms you need are on page 2 of the *Study Guide and Working Papers.*)

The date is November 30, 200X. Use the following information to prepare in proper form a balance sheet for Janning Company:

Accounts Payable	$40,000
Cash	18,000
A. Janning, Capital	9,000
Office Equipment	31,000

Solution to Self-Review Quiz 1-2

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FIGURE 1.3

Balance Sheet

JANNING COMPANY
BALANCE SHEET
NOVEMBER 30, 200X

Assets		Liabilities and Owner's Equity	
Cash	$18000 00	Liabilities	
Office Equipment	31000 00	Accounts Payable	$ 40000 00
		Owner's Equity	
		A. Janning, Capital	9000 00
		Total Liabilities and	
Total Assets	$49000 00	Owner's Equity	$ 49000 00

Accounting Cycle Tutorial
Ajusting & Closing The Books

Capital does not mean cash. The capital amount is the owner's current investment of assets in the business.

Learning Unit 1-3 The Accounting Equation Expanded: Revenue, Expenses, and Withdrawals

As soon as Mia Wong's office opened, she began performing legal services for her clients and earning revenue for the business. At the same time, as a part of doing business, she incurred various expenses, such as rent.

When Mia asked her accountant how these transactions fit into the accounting equation, she began by defining some terms.

Remember: Accounts receivable results from earning revenue even when cash is not yet received.

Record an expense when it is incurred, whether it is paid immediately or is to be paid later.

REVENUE A service company earns **revenue** when it provides services to its clients. Mia's law firm earned revenue when she provided legal services to her clients for legal fees. When revenue is earned, owner's equity is increased. In effect, revenue is a subdivision of owner's equity.

Assets are increased. The increase is in the form of cash if the client pays right away. If the client promises to pay in the future, the increase is called **accounts receivable.** When revenue is earned, the transaction is recorded as an increase in revenue and an increase in assets (either as cash or as accounts receivable, depending on whether it was paid right away or will be paid in the future).

EXPENSES A business's **expenses** are the costs the company incurs in carrying on operations in its effort to create revenue. Expenses are also a subdivision of owner's equity; when expenses are incurred, they *decrease* owner's equity. Expenses can be paid for in cash or they can be charged.

NET INCOME/NET LOSS When revenue totals more than expenses, **net income** is the result; when expenses total more than revenue, **net loss** is the result.

WITHDRAWALS At some point Mia Wong may need to withdraw cash or other assets from the business to pay living or other personal expenses that do not relate to the business. We will record these transactions in an account called **withdrawals.** Sometimes this account is called the *owner's drawing account.* Withdrawals is a subdivision of owner's equity that records personal expenses not related to the business. Withdrawals decrease owner's equity (see Fig. 1.4).

It is important to remember the difference between expenses and withdrawals. Expenses relate to business operations; withdrawals are the result of personal needs outside the normal operations of the business.

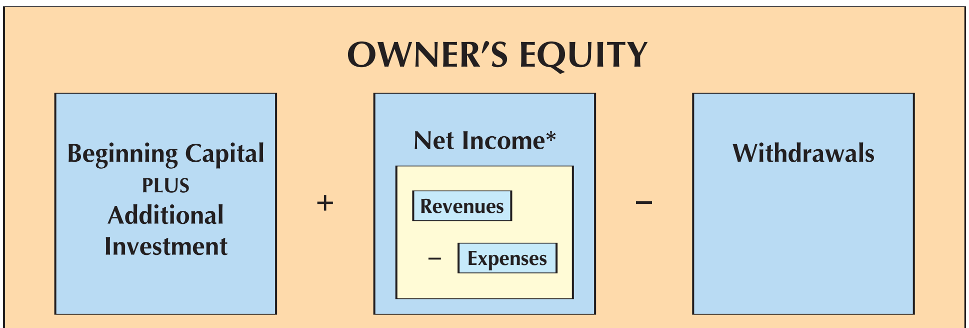
Now let's analyze the September transactions for Mia Wong's law firm using an **expanded accounting equation** that includes withdrawals, revenues, and expenses.

Expanded Accounting Equation

Transaction D Sept. 1–30: Provided legal services for cash, $2,000.

FIGURE 1.4

Owner's Equity



*If expenses are greater than revenues, then a net loss would result. This loss would be subtracted from capital because it would be a negative number.

Transactions A, B, and C were discussed earlier, when the law office was being formed in August. See Learning Unit 1.1.

Assets			= Liabilities +	Owner's Equity				
Cash	**+ Accts. Rec.**	**+ Office Equip.**	**= Accts. Pay.**	**+ M. Wong, Capital**	**− M. Wong, Withdr.**	**+ Revenue**	**− Expenses**	
$5,500		+ $1,000	= $ 300	+ $6,200				**BALANCE FORWARD**
+2,000						**+ $2,000**		
$7,500		+ $1,000	= $ 300	+ $6,200		+ $2,000		**ENDING BALANCE**

$8,500 = $8,500

In the law firm's first month of operation, a total of $2,000 in cash was received for legal services performed. In the accounting equation, the asset Cash is increased by $2,000. Revenue is also increased by $2,000, resulting in an increase in owner's equity.

A revenue column was added to the basic accounting equation. Amounts are recorded in the revenue column when they are earned. They are also recorded in the assets column, either under Cash and/or under Accounts Receivable. Do not think of revenue as an asset. It is part of owner's equity. It is the revenue that creates an inward flow of cash and accounts receivable.

Transaction E Sept. 1–30: Provided legal services on account, $3,000.

Assets			= Liabilities +	Owner's Equity				
Cash	**+ Accts. Rec.**	**+ Office Equip.**	**= Accts. Pay.**	**+ M. Wong, Capital**	**− M. Wong, Withdr.**	**+ Revenue**	**− Expenses**	
$7,500		+ $ 1,000	= $ 300	+ $6,200		+ $2,000		**BAL. FOR. TRANS.**
	+3,000					**+ $3,000**		
$7,500	+ $3,000	+ $ 1,000	= $ 300	+ $6,200		+ $5,000		**END. BAL.**

$11,500 = $11,500

Mia's law practice performed legal work on account for $3,000. The firm did not receive the cash for these earned legal fees; it accepted an unwritten promise from these clients that payment would be received in the future.

Transaction F Sept. 1–30: Received $900 cash as partial payment from previous services performed on account.

During September some of Mia's clients who had received services and promised to pay in the future decided to reduce what they owed the practice by making payment of $900. This decision is shown as follows on the expanded accounting equation.

Assets			= Liabilities +	Owner's Equity				
Cash	**+ Accts. Rec.**	**+ Office Equip.**	**= Accts. Pay.**	**+ M. Wong, Capital**	**− M. Wong, Withdr.**	**+ Revenue**	**− Expenses**	
$7,500	+ $3,000	+ $ 1,000	= $ 300	+ $6,200		+ $5,000		**BAL. FOR. TRANS.**
+900	**−900**							
$8,400	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000		**END. BAL.**

$11,500 = $11,500

The law firm increased the asset Cash by $900 and reduced another asset, Accounts Receivable, by $900. The *total* of assets does not change. The right-hand side of the expanded accounting equation has not been touched because the total on the left-hand side of the equation has not changed. The revenue was recorded when it was earned, and the *same revenue cannot be recorded twice.* This transaction analyzes the situation *after* the revenue has been previously earned and recorded. Transaction F shows a shift in assets: more cash and less accounts receivable.

Transaction G Sept. 1–30: Paid salaries expense, $7,00.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BAL. FOR TRANS.	$8,400	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	
	−700							+$700
END. BAL.	$7,700	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $700
			$10,800	= $10,800				

As expenses increase, they decrease owner's equity. This incurred expense of $700 reduces the cash by $700. Although the expense was paid, the total of our expenses to date has *increased* by $700. Keep in mind that owner's equity decreases as expenses increase, so the accounting equation remains in balance.

Transaction H Sept. 1–30: Paid rent expense, $400.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BAL. FOR TRANS.	$7,700	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $ 700
	−400							+400
END. BAL.	$7,300	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $1,100
			$10,400	= $10,400				

During September the practice incurred rent expenses of $400. This rent was not paid in advance; it was paid when it came due. The payment of rent reduces the asset Cash by $400 as well as increases the expenses of the firm, resulting in a decrease in owner's equity. The firm's expenses are now $1,100.

Transaction I Sept. 1–30: Incurred advertising expenses of $200, to be paid next month.

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
BAL. FOR TRANS.	$7,300	+ $2,100	+ $ 1,000	= $ 300	+ $6,200		+ $5,000	− $1,100
				+200				+200
END. BAL.	$7,300	+ $2,100	+ $ 1,000	= $ 500	+ $6,200		+ $5,000	− $1,300
			$10,400	= $10,400				

Mia ran an ad in the local newspaper and incurred an expense of $200. This increase in expenses caused a corresponding decrease in owner's equity. Because Mia has not paid the newspaper for the advertising yet, she owes $200. Thus her liabilities (Accounts Payable) increase by $200. Eventually, when the bill comes in and is paid, both Cash and Accounts Payable will be decreased.

Transaction J Sept. 1–30: Mia withdrew $100 for personal use.

Assets			= Liabilities +	Owner's Equity				
Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses	
$7,300	+ $2,100	+ $ 1,000	= $ 500	+ $6,200		+ $5,000	− $1,300	**BAL. FOR. TRANS.**
–100					+$100			
$7,200	+ $2,100	+ $ 1,000	= $ 500	+ $6,200	− $100	+ $5,000	− $1,300	**END. BAL.**

$10,300 = $10,300

By taking $100 for personal use, Mia *increased* her withdrawals from the business by $100 and decreased the asset Cash by $100. Note that as withdrawals increase, the owner's equity *decreases*. Keep in mind that a withdrawal is *not* a business expense. It is a subdivision of owner's equity that records money or other assets an owner withdraws from the business for *personal* use.

Subdivision of Owner's Equity Take a moment to review the subdivisions of owner's equity:

- As capital increases, owner's equity increases (see transaction A).
- As withdrawals increase, owner's equity decreases (see transaction J).
- As revenue increases, owner's equity increases (see transaction D).
- As expenses increase, owner's equity decreases (see transaction G).

Mia Wong's Expanded Accounting Equation The following is a summary of the expanded accounting equation for Mia Wong's law firm.

Mia Wong
Attorney-at-Law
Expanded Accounting Equation: A Summary

Assets			= Liabilities +	Owner's Equity				
Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses	
$6,000		+$200 =		+ $6,200				**A.**
6,000		+ 200 =		6,200				**BALANCE**
–500		+500						**B.**
5,500		+ 700 =		6,200				**BALANCE**
		+ 300 +	$300					**C.**
5,500		+ 1,000 =	300	+ 6,200				**BALANCE**
+2,000						+$2,000		**D.**
7,500		+ 1,000 =	300	+ 6,200		+ 2,000		**BALANCE**
	+ $3,000					+3,000		**E.**
7,500 +	3,000 +	1,000 =	300	+ 6,200		+ 5,000		**BALANCE**

(continued)

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Office Equip.	= Accts. Pay.	+ M. Wong, Capital	− M. Wong, Withdr.	+ Revenue	− Expenses
F.	**+900**	**−900**						
BALANCE	8,400 +	2,100 +	1,000 =	300	+ 6,200		+ 5,000	
G.	**−700**							**+$700**
BALANCE	7,700 +	2,100 +	1,000 =	300	+ 6,200		+ 5,000	− 700
H.	**−400**							**+400**
BALANCE	7,300 +	2,100 +	1,000 =	300	+ 6,200		+ 5,000	− 1,100
I.				+ 200				+200
BALANCE	7,300 +	2,100 +	1,000 =	500	+ 6,200		+ 5,000	− 1,300
J.	**−100**					**+$100**		
END BALANCE	$7,200 +	$2,100 +	$ 1,000 =	$ 500	+ $6,200	− $100	+ $5,000	− $1,300

$10,300 = $10,300

Learning Unit 1-3 Review

AT THIS POINT you should be able to

- Define and explain the difference between revenue and expenses. (p. 12)
- Define and explain the difference between net income and net loss. (p. 12)
- Explain the subdivisions of owner's equity. (p. 12)
- Explain the effects of withdrawals, revenue, and expenses on owner's equity. (p. 12)
- Record transactions in an expanded accounting equation and balance the basic accounting equation as a means of checking the accuracy of your calculations. (p. 12)

For additional help go to www.prenhall.com/slater

QUIZ TIP:
Think of expenses and withdrawals as increasing. As they increase, they will reduce the owner's rights. For example, Transaction 4 withdrawals increased by $500, resulting in withdrawals increasing from $800 to $1,300, which represents a $500 decrease to owner's equity.

Self-Review Quiz 1-3

(The blank forms you need are on page 3 of the *Study Guide and Working Papers.*)

Record the following transactions into the expanded accounting equation for the Bing Company. Note that all titles have a beginning balance.

1. Received cash revenue, $4,000.
2. Billed customers for services rendered, $6,000.
3. Received a bill for telephone expenses (to be paid next month), $125.
4. Bob Bing withdrew cash for personal use, $500.
5. Received $1,000 from customers in partial payment for services performed in transaction 2.

Solution to Self-Review Quiz 1-3

	Assets			= Liabilities +	Owner's Equity			
	Cash	+ Accts. Rec.	+ Cleaning Equip.	= Accts. Pay.	+ B. Bing, Capital	− B. Bing, Withdr.	+ Revenue	− Expenses
BEG. BALANCE	$10,000 +	$ 2,500 +	$ 6,500 =	$ 1,000	+ $11,800	− $ 800	+ $ 9,000	− $2,000
1.	**+4,000**						**+4,000**	
BALANCE	14,000 +	2,500 +	6,500 =	1,000	+ 11,800	− 800	+ 13,000	− 2,000
2.		+6,000					+6,000	
BALANCE	14,000 +	8,500 +	6,500 =	1,000	+ 11,800	− 800	+ 19,000	− 2,000

			+125				+125	**3.**
14,000 +	8,500 +	6,500 =	1,125	+ 11,800 −	800	+ 19,000 −	2,125	**BALANCE**
−500					+500			**4.**
13,500 +	8,500 +	6,500 =	1,125	+ 11,800 −	1,300	+ 19,000 −	2,125	**BALANCE**
+1,000	−1,000							**5.**
$14,500 +	$ 7,500 +	$ 6,500 =	$ 1,125	+ $11,800 −	$1,300	+ $19,000 −	$2,125	**END. BALANCE**
		$28,500 =	$28,500					

Learning Unit 1-4 Preparing Financial Statements

Mia Wong would like to be able to find out whether her firm is making a profit, so she asks her accountant whether he can measure the firm's financial performance on a monthly basis. Her accountant replies that a number of financial statements that he can prepare, such as the income statement, will show Mia how well the law firm has performed over a specific period of time. The accountant can use the information in the income statement to prepare other reports.

The Income Statement

An **income statement** is an accounting statement that shows business results in terms of revenue and expenses. If revenues are greater than expenses, the report shows net income. If expenses are greater than revenues, the report shows net loss. An income statement can cover 1, 3, 6, or 12 months. It cannot cover more than one year. The statement shows the result of all revenues and expenses throughout the entire period and not just as of a specific date. The income statement for Mia Wong's law firm is shown in Figure 1.5.

Points to Remember in Preparing an Income Statement

HEADING The heading of an income statement tells the same three things as all other accounting statements: the company's name, the name of the statement, and the period of time the statement covers.

THE SETUP As you can see on the income statement, the inside column of numbers ($700, $400, and $200) is used to subtotal all expenses ($1,300) before subtracting them from revenue ($5,000 − $1,300 = $3,700).

The income statement is prepared from data found in the revenue and expense columns of the expanded accounting equation. The inside column of numbers ($700, $400, $200) is used to subtotal all expenses ($1,300) before subtracting from revenue.

FIGURE 1.5

The Income Statement

MIA WONG, ATTORNEY-AT-LAW
INCOME STATEMENT
FOR MONTH ENDED SEPTEMBER 30, 200X

Revenue:		
Legal Fees		$ 5 0 0 0 00
Operating Expenses:		
Salaries Expense	$ 7 0 0 00	
Rent Expense	4 0 0 00	
Advertising Expense	2 0 0 00	
Total Operating Expenses		1 3 0 0 00
Net Income		$ 3 7 0 0 00

Software programs may call this statement a profit and loss statement or an earnings statement.

Operating expenses may be listed in alphabetical order, in order of largest amounts to smallest, or in a set order established by the accountant.

The Statement of Owner's Equity

If this statement of owner's equity is omitted, the information will be included in the owner's equity section of the balance sheet.

As we said, the income statement is a business statement that shows business results in terms of revenue and expenses, but how does net income or net loss affect owner's equity? To find out, we have to look at a second type of statement, the **statement of owner's equity.**

The statement of owner's equity shows for a certain period of time what changes occurred in Mia Wong, Capital. The statement of owner's equity is shown in Figure 1.6.

The capital of Mia Wong can be

Increased by: Owner Investment
Net Income (Revenue − Expenses) and Revenue Greater Than Expenses
Decreased by: Owner Withdrawals
Net Loss (Revenue − Expenses) and Expenses Greater Than Revenue

Remember, a withdrawal is *not* a business expense and thus is not involved in the calculation of net income or net loss on the income statement. It appears on the statement of owner's equity. The statement of owner's equity summarizes the effects of all the subdivisions of owner's equity (revenue, expenses, withdrawals) on beginning capital. The ending capital figure ($9,800) will be the beginning figure in the next statement of owner's equity.

Suppose Mia's law firm had operated at a loss in the month of September. Suppose instead of net income, a $400 net loss occurred and an additional investment of $700 was made on September 15. Figure 1.7 shows how the statement would look with this net loss and additional investment.

The Balance Sheet

Now let's look at how to prepare a balance sheet from the expanded accounting equation (see Fig. 1.8). As you can see, the asset accounts (cash, accounts receivable, and office equipment) appear on the left side of the balance sheet.

Accounts payable and Mia Wong, Capital appear on the right side. Notice that the $9,800 of capital can be calculated within the accounting equation or can be read from the statement of owner's equity.

FIGURE 1.6

Statement of Owner's Equity—Net Income

This statement, called a statement of retained earnings in Peachtree, is not available as a report in QuickBooks.

MIA WONG, ATTORNEY-AT-LAW
STATEMENT OF OWNER'S EQUITY
FOR MONTH ENDED SEPTEMBER 30, 200X

Mia Wong, Capital, September 1, 200X		$ 6 2 0 0 00
Net Income for September	$ 3 7 0 0 00	
Less Withdrawals for September	1 0 0 00	
Increase in Capital		3 6 0 0 00
Mia Wong, Capital, September 30, 200X		$ 9 8 0 0 00

Comes from Income Statement

FIGURE 1.7

Statement of Owner's Equity—Net Loss

MIA WONG, ATTORNEY-AT-LAW STATEMENT OF OWNER'S EQUITY FOR MONTH ENDED SEPTEMBER 30, 200X		
Mia Wong, Capital, September 1, 200X		$ 6,200 00
Additional Investment, September 15, 200X		700 00
Total Investment for September*		$ 6,900 00
Less: Net Loss for September	$ 400 00	
Withdrawals for September	100 00	
Decrease in Capital		500 00
Mia Wong, Capital, September 30, 200X		$ 6,400 00

*Beginning capital and additional investments.

Main Elements of the Income Statement, the Statement of Owner's Equity, and the Balance Sheet

In this chapter we have discussed three financial statements: the income statement, the statement of owner's equity, and the balance sheet. A fourth statement, called the statement of cash flows, will not be covered at this time. Let us review what elements of the expanded accounting equation go into each statement and the usual order in which the statements are prepared. Figure 1.8 presents a diagram of the accounting equation and the balance sheet. Table 1.3 summarizes the following points:

- The income statement is prepared first; it includes revenues and expenses and shows net income or net loss. This net income or net loss is used to update the next statement, the statement of owner's equity.
- The statement of owner's equity is prepared second; it includes beginning capital and any additional investments, the net income or net loss shown on the income

FIGURE 1.8

The Accounting Equation and the Balance Sheet

Net income is reported separately from capital on the balance sheet in the equity section in both QuickBooks and Peachtree.

MIA WONG, ATTORNEY-AT-LAW BALANCE SHEET SEPTEMBER 30, 200X			
Assets		Liabilities and Owner's Equity	
Cash	$ 7,200 00	Liabilities	
Accounts Receivable	2,100 00	Accounts Payable	$ 500 00
Office Equipment	1,000 00	Owner's Equity	
		Mia Wong, Capital	9,800 00
		Total Liabilities and	
Total Assets	$ 10,300 00	Owner's Equity	$ 10,300 00

$9,800 comes from ending capital figure on statement of owner's equity

	ASSETS			=	LIABILITIES	+	OWNER'S EQUITY			
	Cash	+ Accts. Rec.	+ Office Equip.	=	Accts. Pay.		+M. Wong, Capital	– M. Wong, Withdr.	+ Revenue	– Expenses
END. BAL.	$7,200	+$2,100	+ $1,000	=	$500		+$6,200	– $100	+$5,000	–$1,300
	$10,300				$10,300					

Table 1.3 What Goes on Each Financial Statement

	Income Statement	Statement of Owner's Equity	Balance Sheet
Assets			X
Liabilities			X
Capital* (beg.)		X	
Capital (end)		X	X
Withdrawals		X	
Revenues	X		
Expenses	X		

**Note:* Additional Investments go on the statement of owner's equity.

statement, withdrawals, and the total, which is the **ending capital.** The balance in Capital comes from the statement of owner's equity.

- The balance sheet is prepared last; it includes the final balances of each of the elements listed in the accounting equation under Assets and Liabilities. The balance in Capital comes from the statement of owner's equity.

Learning Unit 1-4 Review

AT THIS POINT you should be able to

- Define and state the purpose of the income statement, the statement of owner's equity, and the balance sheet. (p. 17)
- Discuss why the income statement should be prepared first. (p. 17)
- Show what happens on a statement of owner's equity when a net loss occurs. (p. 18)
- Compare and contrast these three financial statements. (p. 19)
- Calculate a new figure for capital on the statement of owner's equity and the balance sheet. (p. 19)

Self-Review Quiz 1-4

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(The blank forms you need are on pages 4 and 5 of the *Study Guide and Working Papers.*)
From the following balances for Rusty Realty prepare:

1. Income statement for the month ended November 30, 200X.
2. Statement of owner's equity for the month ended November 30, 200X.
3. Balances as of November 30, 200X.

Cash	$4,000	R. Rusty, Capital	
Accounts Receivable	1,370	November 1, 200X	$5,000
Store Furniture	1,490	R. Rusty, Withdrawals	100
Accounts Payable	900	Commissions Earned	1,500
		Rent Expense	200
		Advertising Expense	150
		Salaries Expense	90

Solution to Self-Review Quiz 1-4

FIGURE 1.9

Financial Reports

RUSTY REALTY
INCOME STATEMENT
FOR MONTH ENDED NOVEMBER 30, 200X

Revenue:		
Commissions Earned		$ 1,500.00
Operating Expenses:		
Rent Expense	$ 200.00	
Advertising Expense	150.00	
Salaries Expense	90.00	
Total Operating Expenses		440.00
Net Income		$ 1,060.00

Subtotal Columns

RUSTY REALTY
STATEMENT OF OWNER'S EQUITY
FOR MONTH ENDED NOVEMBER 30, 200X

R. Rusty, Capital, November 1, 200X		$ 5,000.00
Net Income for November	$ 1,060.00	
Less Withdrawals for November	100.00	
Increase in Capital		960.00
R. Rusty, Capital, November 30, 200X		$ 5,960.00

QUIZ TIP:
The net income from the income statement is used to help build the statement of owner's equity.

RUSTY REALTY
BALANCE SHEET
NOVEMBER 30, 200X

Assets		Liabilities and Owner's Equity	
Cash	$ 4,000.00	Liabilities	
Accounts Receivable	1,370.00	Accounts Payable	$ 900.00
Store Furniture	1,490.00		
		Owner's Equity	
		R. Rusty, Capital	5,960.00
		Total Liabilities and	
Total Assets	$ 6,860.00	Owner's Equity	$ 6,860.00

The new figure for capital from the statement of owner's equity is used as the capital figure on the balance sheet.

Demonstration Problem

(The blank forms you need are on pages 6 and 7 of the *Study Guide and Working Papers.*)

Michael Brown opened his law office on June 1, 200X. During the first month of operations, Michael conducted the following transactions:

1. Invested $6,000 in cash into the law practice.
2. Paid $600 for office equipment.
3. Purchased additional office equipment on account, $1,000.
4. Received cash for performing legal services for clients, $2,000.
5. Paid salaries, $800.
6. Performed legal services for clients on account, $1,000.
7. Paid rent, $1,200.
8. Withdrew $500 from his law practice for personal use.
9. Received $500 from customers in partial payment for legal services performed, transaction 6.

Assignment

Record these transactions in the expanded accounting equation.
Prepare the financial statements at June 30 for Michael Brown, Attorney-at-Law.

Solution to Demonstration Problem

	Assets					= Liabilities +			Owner's Equity						
A.	Cash	+	Accts. Rec.	+	Office Equip.	=	Accounts Payable	+	M. Brown, Capital	−	M. Brown, Withdr.	+	Legal Fees	−	Expenses
1.	+$6,000								+$6,000						
BAL.	6,000					=			6,000						
2.	–600				+$600										
BAL.	5,400			+	600	=			6,000						
3.					+1,000		+$1,000								
BAL.	5,400			+	1,600	=	1,000	+	6,000						
4.	+2,000												+$2,000		
BAL.	7,400			+	1,600	=	1,000	+	6,000			+	2,000		
5.	–800														+$800
BAL.	6,600			+	1,600	=	1,000	+	6,000			+	2,000	−	800
6.			+$1,000										+1,000		
BAL.	6,600	+	1,000	+	1,600	=	1,000	+	6,000			+	3,000	−	800
7.	–1,200														+1,200
BAL.	5,400	+	1,000	+	1,600	=	1,000	+	6,000			+	3,000	−	2,000
8.	–500										+$500				
BAL.	4,900	+	1,000	+	1,600	=	1,000	+	6,000	−	500	+	3,000	−	2,000
9.	+500		–500												
END. BAL.	$5,400	+	$ 500	+	$1,600	=	$1,000	+	$6,000	−	$500	+	$3,000	−	$2,000
					$7,500	=	$7,500								

Solution Tips to Expanded Accounting Equation

- **Transaction 1:** The business increased its Cash by $6,000. Owner's Equity (capital) increased when Michael supplied the cash to the business.
- **Transaction 2:** A shift in assets occurred when the equipment was purchased. The business lowered its Cash by $600, and a new column—Office Equipment—was increased for the $600 of equipment that was bought. The amount of capital is not touched because the owner did not supply any new funds.
- **Transaction 3:** When creditors supply $1,000 of additional equipment, the business Accounts Payable shows the debt. The business had increased what it *owes* the creditors.
- **Transaction 4:** Legal Fees, a subdivision of Owner's Equity, is increased when the law firm provides a service even if no money is received. The service provides an inward flow of $2,000 to Cash, an asset. Remember that Legal Fees are *not* an asset. As Legal Fees increase, Owner's Equity increases.
- **Transaction 5:** The salary paid by Michael shows an $800 increase in Expenses and a corresponding decrease in Owner's Equity, as well as a decrease in Cash.
- **Transaction 6:** Michael did the work and earned the $1,000. That $1,000 is recorded as revenue. This time the Legal Fees create an inward flow of assets called Accounts Receivable for $1,000. Remember that Legal Fees are *not* an asset. They are a subdivision of Owner's Equity.
- **Transaction 7:** The $1,200 rent expense reduces Owner's Equity as well as Cash.
- **Transaction 8:** Withdrawals are for personal use. Here, the business decreases Cash by $500 while Michael's withdrawals increase $500. Withdrawals decrease the Owner's Equity.
- **Transaction 9:** This transaction does not reflect new revenue in the form of Legal Fees. It is only a shift in assets: more Cash and less Accounts Receivable.

B-1.

MICHAEL BROWN, ATTORNEY-AT-LAW
INCOME STATEMENT
FOR MONTH ENDED JUNE 30, 200X

Revenue:		
Legal Fees		$3,000
Operating Expenses:		
Salaries Expense	$ 800	
Rent Expense	1,200	
Total Operating Expenses		2,000
Net Income		$1,000

B-2.

MICHAEL BROWN, ATTORNEY-AT-LAW
STATEMENT OF OWNER'S EQUITY
FOR MONTH ENDED JUNE 30, 200X

Michael Brown, Capital, June 1, 200X		$6,000
Net income for June	$1,000	
Less withdrawls for June	500	
Increase in Capital		500
Michael Brown, Capital, June 30, 200X		$6,500

(continued)

B-3.

MICHAEL BROWN, ATTORNEY-AT-LAW
BALANCE SHEET
JUNE 30, 200X

Assets		**Liabilities and Owner's Equity**	
Cash	**$5,400**	Liabilities	
Accounts Receivable	**500**	Accounts Payable	**$1,000**
Office Equipment	**1,600**	Owner's Equity	
		M. Brown, Capital	**$6,500**
Total Assets	**$7,500**	Total Liabilities and Owner's Equity	**$7,500**

Solution Tips to Financial Statements

B-1. The income statement lists only revenues and expenses for a period of time. The inside column is for subtotaling. Withdrawals are not listed here.

B-2. The statement of owner's equity takes the net income figure of $1,000 and adds it to beginning capital less any withdrawals. This new capital figure of $6,500 will go on the balance sheet. This statement shows changes in capital for a period of time.

B-3. The $5,400, $500, $1,600, and $1,000 came from the totals of the expanded accounting equation. The capital figure of $6,500 came from the statement of owner's equity. This balance sheet reports assets, liabilities, and a new figure for capital at a specific date.

CHAPTER ASSIGNMENTS

Summary of Key Points

Learning Unit 1-1

1. The Sarbanes-Oxley rule helps prevent fraud at trading companies.
2. The functions of accounting involve analyzing, recording, classifying, summarizing, reporting, and interpreting financial information.
3. A sole proprietorship is a business owned by one person. A partnership is a business owned by two or more persons. A corporation is a business owned by stockholders. All forms of business organizations are found in Internet businesses.
4. Bookkeeping is the recording part of accounting.
5. The computer is a tool to use in the accounting process.
6. Assets = Liabilities + Owner's Equity is the basic accounting equation that aids in analyzing business transactions.
7. Liabilities represent amounts owed to creditors, whereas capital represents what is invested by the owner.
8. Capital does not mean cash. Capital is the owner's current investment. The owner could have invested equipment that was purchased before the new business was started.
9. In a shift of assets, the composition of assets changes, but the total of assets does not change. For example, if a bill is paid by a customer, the firm increases Cash (an asset) but decreases Accounts Receivable (an asset), so no overall increase in assets occurs; total assets remain the same. When you borrow money from a bank, you have an increase in cash (an asset) and an increase in liabilities; overall, assets increase rather than simply shift.

Learning Unit 1-2

1. The balance sheet is a statement written as of a particular date. It lists the assets, liabilities, and owner's equity of a business. The heading of the balance sheet answers the questions *who, what,* and *when* (as of a specific date).
2. The balance sheet is a formal statement of a financial position.

Learning Unit 1-3

1. Revenue generates an inward flow of assets. Expenses generate an outward flow of assets or a potential outward flow. Revenue and expenses are subdivisions of owner's equity. Revenue is not an asset.
2. When revenue totals more than expenses, net income is the result; when expenses total more than revenue, net loss is the result.
3. Owner's equity can be subdivided into four elements: capital, withdrawals, revenue, and expenses.
4. Withdrawals decrease owner's equity, revenue increases owner's equity, and expenses decrease owner's equity. A withdrawal is not a business expense; it is for personal use.

Learning Unit 1-4

1. The income statement is a statement written for a specific period of time that lists earned revenue and expenses incurred to produce the earned revenue. The net income or net loss will be used in the statement of owner's equity.
2. The statement of owner's equity reveals the causes of a change in capital. This statement lists any investments, net income (or net loss), and withdrawals. The ending figure for capital will be used on the balance sheet.
3. The balance sheet uses the ending balances of assets and liabilities from the accounting equation and the capital from the statement of owner's equity.
4. The income statement should be prepared first because the information on it about net income or net loss is used to prepare the statement of owner's equity, which in turn provides information about capital for the balance sheet. In this way one statement builds upon the next, beginning with the income statement.

Key Terms

Accounting A system that measures the business's activities in financial terms, provides written reports and financial statements about those activities, and communicates these reports to decision makers and others.

Accounts payable Amounts owed to creditors that result from the purchase of goods or services on account: a liability.

Accounts receivable An asset that indicates amounts owed by customers.

Assets Properties (resources) of value owned by a business (cash, supplies, equipment, land).

Balance sheet A statement, as of a particular date, that shows the amount of assets owned by a business as well as the amount of claims (liabilities and owner's equity) against these assets.

Basic accounting equation Assets = Liabilities + Owner's Equity.

Bookkeeping The recording function of the accounting process.

Capital The owner's investment of equity in the company.

Corporation A type of business organization that is owned by stockholders. Stockholders usually are not personally liable for the corporation's debts.

Creditor Someone who has a claim to assets.

Ending capital Beginning Capital + Additional Investments + Net Income − Withdrawals = Ending Capital. Or: Beginning Capital + Additional Investments − Net Loss − Withdrawals = Ending Capital.

Equities The interest or financial claim of creditors (liabilities) and owners (owner's equity) who supply the assets to a firm.

Expanded accounting equation Assets = Liabilities + Capital − Withdrawals + Revenue − Expenses.

Expense A cost incurred in running a business by consuming goods or services in producing revenue; a subdivision of owner's equity. When expenses increase, there is a decrease in owner's equity.

Generally accepted accounting principles (GAAP) The procedures and guidelines that must be followed during the accounting process.

Income statement An accounting statement that details the performance of a firm (revenue minus expenses) for a specific period of time.

Liabilities Obligations that come due in the future. Liabilities result in increasing the financial rights or claims of creditors to assets.

Manufacturer Business that makes a product and sells it to its customers.

Merchandise company Business that buys a product from a manufacturing company to sell to its customers.

Net income When revenue totals more than expenses, the result is net income.

Net loss When expenses total more than revenue, the result is net loss.

Owner's equity Rights or financial claims to the assets of a business (in the accounting equation, assets minus liabilities).

Partnership A form of business organization that has at least two owners. The partners usually are personally liable for the partnership's debts.

Revenue An amount earned by performing services for customers or selling goods to customers; it can be in the form of cash or accounts receivable. A subdivision of owner's equity: As revenue increases, owner's equity increases.

Service company Business that provides a service.

Shift in assets A shift that occurs when the composition of the assets has changed, but the total of the assets remains the same.

Sole proprietorship A type of business ownership that has one owner. The owner is personally liable for paying the business's debts.

Statement of financial position Another name for a balance sheet.

Statement of owner's equity A financial statement that reveals the change in capital. The ending figure for capital is then placed on the balance sheet.

Supplies One type of asset acquired by a firm; it has a much shorter life than equipment.

Withdrawals A subdivision of owner's equity that records money or other assets an owner withdraws from a business for personal use.

Blueprint: Financial Statements

1 Income Statement

Measuring performance

Revenue:		XXX
Operating Expenses	XX	
Other Expenses	XX	XXX
Net Income		XXX

2 Statement of Owner's Equity

Calculating new figure for capital

Beginning Capital		XXX
Additional Investments		XXX
Total Investments		XXX
Net Income (or loss)	XXX	
Less Withdrawals	XXX	
Increase in Capital (or decrease)		XXX
Ending Capital		XXX

3 Balance Sheet

Where do we now stand

Assets		Liabilities and Owner's Equity	
	XXX	Liabilities	XXX
	XXX	Owner's Equity	
	XXX	Ending Capital	XXX
Total Assets	XXX	Total Liab. + OE	XXX

Questions, Classroom Demonstration Exercises, Exercises, and Problems

Discussion Questions and Critical Thinking/Ethical Case

1. What are the functions of accounting?
2. Define, compare, and contrast sole proprietorships, partnerships, and corporations.
3. How are businesses classified?
4. What is the relationship of bookkeeping to accounting?
5. List the three elements of the basic accounting equation.
6. Define capital.
7. The total of the left-hand side of the accounting equation must equal the total of the right-hand side. True or false? Please explain.
8. A balance sheet tells a company where it is going and how well it performs. True or false? Please explain.
9. Revenue is an asset. True or false? Please explain.
10. Owner's equity is subdivided into what categories?
11. A withdrawal is a business expense. True or false? Please explain.
12. As expenses increase they cause owner's equity to increase. Defend or reject.
13. What does an income statement show?
14. The statement of owner's equity only calculates ending withdrawals. True or false? Please explain.
15. Paul Kloss, accountant for Lowe & Co., traveled to New York on company business. His total expenses came to $350. Paul felt that because the trip extended over the weekend he would "pad" his expense account with an additional $100 of expenses. After all, weekends represent his own time, not the company's. What would you do? Write your specific recommendations to Paul.

Classroom Demonstration Exercises

(The blank forms you need are on page 8 of the *Study Guide and Working Papers.*)

Set A

Classifying Accounts

1. Classify each of the following items as an Asset (A), Liability (L), or part of Owner's Equity (OE).
   - **a.** Sony Flat-Screen Television ________
   - **b.** J. Ling, Capital ________
   - **c.** Accounts Payable ________
   - **d.** Cash ________
   - **e.** Computer Supplies ________
   - **f.** Kodak Digital Camera ________

The Accounting Equation

2. Complete the following statements.
   - **a.** ________: rights of the creditors
   - **b.** ________ are total value of items owned by a business.
   - **c.** ________ ________ is an unwritten promise to pay the creditor.

Shift Versus Increase in Assets

3. Identify which transaction results in a shift in assets (S) and which transaction causes an increase in assets (I).
   - **a.** Staples bought computer equipment on account.
   - **b.** J.C. Penney bought office equipment for cash.

The Balance Sheet

4. From the following, calculate what would be the total of assets on the balance sheet.

Lee Winn, Capital	$14,000
Computer Equipment	2,000
Accounts Payable	5,000
Cash	17,000

The Accounting Equation Expanded

5. From the following, which are subdivisions of owner's equity?

a. Trees ________
b. J. Penny, Capital ________
c. Accounts Payable ________
d. J. Penny, Withdrawals ________
e. Accounts Receivable ________
f. Advertising Expense ________
g. Taxi Fees Earned ________
h. Computer Equipment ________

Identifying Assets

6. Identify which of the following are *not* assets.

a. DVD Player ________
b. Accounts Receivable ________
c. Accounts Payable ________
d. Grooming Fees Earned ________

The Accounting Equation Expanded

7. Which of the following statements are false?

a. ________ Revenue provides only outward flows of cash.
b. ________ Revenue is a subdivision of Assets.
c. ________ Revenue provides an inward flow of cash or accounts receivable.
d. ________ Expenses are part of Total Assets.

Preparing Financial Statements

8. Indicate whether the following items would appear on the income statement (IS), statement of owner's equity (OE), or balance sheet (BS).

a. ________ Tutoring Fees Earned
b. ________ Office Equipment
c. ________ Accounts Receivable
d. ________ Office Supplies
e. ________ Legal Fees Earned
f. ________ Advertising Expenses
g. ________ J. Earl, Capital (Beg.)
h. ________ Accounts Payable

Preparing Financial Statements

9. Indicate next to each statement whether it refers to the income statement (IS), statement of owner's equity (OE), or balance sheet (BS).

a. ________ Withdrawals found on it
b. ________ List total of all assets

c. ________ Statement that is prepared last
d. ________ Statement listing net income

Set B

Classifying Accounts

1. Classify each of the following items as an Asset (A), Liability (L), or part of Owner's Equity (OE).
a. Panasonic DVD ________
b. Accounts Payable ________
c. B. Aster, Capital ________
d. Office Supplies ________
e. Cash ________
f. Sony Digital Camera ________

The Accounting Equation

2. Complete the following statements.
a. A ________ ________ ________ results when the total of the assets remains the same but the makeup of the assets has changed.
b. Assets − ________ = Owner's Equity.
c. Capital does not mean ________.

Shift Versus Increase in Assets

3. Identify which transaction results in a shift in assets (S) and which transaction causes an increase in assets (I).
a. Office Max bought computer equipment for cash.
b. The Gap bought office equipment on account.

The Balance Sheet

4. From the following, calculate what would be the total of assets on the balance sheet.

H. Sung, Capital	$11,000
Word Processing Equipment	1,000
Accounts Payable	2,000
Cash	12,000

The Accounting Equation Expanded

5. From the following, which are subdivisions of owner's equity?
a. Land ________
b. M. Kaminsky, Capital ________
c. Accounts Receivable ________
d. M. Kaminsky, Withdrawals ________
e. Accounts Payable ________
f. Rent Expense ________
g. Office Equipment ________
h. Hair Salon Fees Earned ________

Identifying Assets

6. Identify which of the folloiwng are *not* assets.
a. Fax Machines
b. Accounts Payable
c. Legal Fees Earned
d. Accounts Receivable

The Accounting Equation Expanded

7. Which of the following statements are false?

a. ________ Revenue is an asset.
b. ________ Revenue is a subdivision of Owner's Equity.
c. ________ Revenue provides an inward flow of cash or accounts receivable.
d. ________ Withdrawals are part of Total Assets.

Preparing Financial Statements

8. Indicate whether the following items would appear on the income statement (IS), statement of owner's equity (OE), or balance sheet (BS).

a. ________ B. Clo, Withdrawals
b. ________ Office Supplies
c. ________ Accounts Payable
d. ________ Computer Equipment
e. ________ Commission Fees Earned
f. ________ Salaries Expense
g. ________ B. Clo, Capital (Beg.)
h. ________ Accounts Receivable

Preparing Financial Statements

9. Indicate next to each statement whether it refers to the income statement (IS), statement of owner's equity (OE), or balance sheet (BS).

a. ________ Calculate new figure for capital
b. ________ Prepared as of a particular date
c. ________ Statement that is prepared first
d. ________ Statement listing revenues and expenses

Exercises

(The forms you need are on pages 9–11 of the *Study Guide and Working Papers.*)

1-1. Complete the following table:

	Assets	=	Liabilitites	+	Owner's Equity
a.	$16,000	=	?	+	$2,000
b.	?	=	$6,000	+	$9,000
c.	$10,000	=	$4,000	+	?

1-2. Record the following transactions in the basic accounting equation. Treat each one separately.

Assets = Liabilities + Owner's Equity

a. Matty invests $120,000 in company.
b. Bought equipment for cash, $600.
c. Bought equipment on account, $900.

1-3. From the following, prepare a balance sheet for Jingle Cleaners at the end of November 200X: Cash, $40,000; Cleaning Equipment, $8,000; Accounts Payable, $19,000; J. Jingle, Capital.

1-4. Record the following transactions into the expanded accounting equation. The running balance may be omitted for simplicity.

Assets			= Liabilities +	Owner's Equity			
Cash	+ Accounts Receivable	+ Computer Equipment	= Accounts Payable	+ B. Bell, Capital	− B. Bell, Withdrawals	+ Revenues	− Expenses

a. Bell invested $60,000 in a computer company.
b. Bought computer equipment on account, $7,000.

c. Bell paid personal telephone bill from company checkbook, $200.
d. Received cash for services rendered, $14,000.
e. Billed customers for services rendered for month, $30,000.
f. Paid current rent expense, $4,000.
g. Paid supplies expense, $1,500.

1-5. From the following account balances, prepare in proper form for June (a) an income statement, (b) a statement of owner's equity, and (c) a balance sheet for French Realty.

Cash	$3,310	S. French, Withdrawals	$ 40
Accounts Receivable	1,490	Professional Fees	2,900
Office Equipment	6,700	Salaries Expense	500
Accounts Payable	2,000	Utilities Expense	360
S. French, Capital, June 1, 200X	8,000	Rent Expense	500

Group A Problems

(The forms you need are on pages 12–18 of the *Study Guide and Working Papers.*)

1A-1. Betty Sullivan decided to open Betty's Dog Grooming Center. Betty completed the following transactions:
a. Invested $19,000 cash from her personal bank account into the business.
b. Bought equipment for cash, $3,000.
c. Bought additional equipment on account, $2,000.
d. Paid $300 cash to partially reduce what was owed from transaction C.

Check Figure:
Cash $15,700

Based on this information, record these transactions into the basic accounting equation.

1A-2. Roger Clay is the accountant for Blues Internet Service. From the following information, his task is to construct a balance sheet as of September 30, 200X, in proper form. Could you help him?

Check Figure:
Total Assets $68,000

Building	$40,000	Cash	$12,000
Accounts Payable	20,000	Equipment	16,000
Blues, Capital	48,000		

1A-3. At the end of November, Rick Fox decided to open his own typing service. Analyze the following transactions he completed by recording their effects into the expanded accounting equation.
a. Invested $10,000 in his typing service.
b. Bought new office equipment on account, $4,000.
c. Received cash for typing services rendered, $500.
d. Performed typing services on account, $2,100.
e. Paid secretary's salary, $350.
f. Paid office supplies expense for the month, $210.
g. Rent expenses for office due but unpaid, $900.
h. Withdrew cash for personal use, $400.

Check Figure:
Total Assets $15,640

1A-4. Jane West, owner of West Stenciling Service, has requested that you prepare from the following balances (a) an income statement for June 200X, (b) a statement of owner's equity for June, and (c) a balance sheet as of June 30, 200X.

Check Figure:
Total Assets $3,385

Cash	$2,300	Stenciling Fees	$3,000
Accounts Receivable	400	Advertising Expense	110
Equipment	685	Repair Expense	25
Accounts Payable	310	Travel Expense	250
J. West, Capital, June 1, 200X	1,200	Supplies Expense	190
J. West, Withdrawals	300	Rent Expense	250

1A-5. John Tobey, a retired army officer, opened Tobey's Catering Service. As his accountant, analyze the transactions listed next and present them in proper form.

a. The analysis of the transactions by using the expanded accounting equation.
b. A balance sheet showing the position of the firm before opening for business on October 31, 200X.
c. An income statement for the month of November.
d. A statement of owner's equity for November.
e. A balance sheet as of November 30, 200X.

Check Figure:
Total Assets,
Nov. 30 $24,060

200X	
Oct. 25	John Tobey invested $20,000 in the catering business from his personal savings account.
27	Bought equipment for cash from Munroe Co., $700
28	Bought additional equipment on account from Ryan Co., $1,000.
29	Paid $600 to Ryan Co. as partial payment of the October 28 transaction.

(You should now prepare your balance sheet as of October 31, 200X.)

Nov. 1	Catered a graduation and immediately collected cash, $2,400.
5	Paid salaries of employees, $690.
8	Prepared desserts for customers on account, $300.
10	Received $100 cash as partial payment of November 8 transaction.
15	Paid telephone bill, $60.
17	Paid his home electric bill from the company's checkbook, $90.
20	Catered a wedding and received cash, $1,800.
25	Bought additional equipment on account, $400.
28	Rent expense due but unpaid, $600.
30	Paid supplies expense, $400.

Group B Problems

(The forms you need are on pages XX–XX of the *Study Guide and Working Papers.*)

1B-1. Betty Sullivan began a new business called Betty's Dog Grooming Center. The following transactions resulted:

a. Betty invested $16,000 cash from her personal bank account into the Dog Grooming Center.
b. Bought equipment on account, $1,500.
c. Paid $800 cash to partially reduce what was owed from transaction B.
d. Purchased additional equipment for cash, $3,000.

Check Figure:
Cash $12,200

Record these transactions into the basic accounting equation.

Check Figure:
Total Assets $84,000

1B-2. Roger Clay, accountant, has asked you to prepare a balance sheet as of September 30, 200X, for Blues Internet Service. Could you assist Roger?

Blues, Capital	$24,000
Accounts Payable	60,000
Equipment	40,000
Building	28,000
Cash	16,000

1B-3. Rick Fox decided to open his own typing service company at the end of November. Analyze the following transactions by recording their effects on the expanded accounting equation:

a. Rick invested $9,000 in the typing service.
b. Purchased new office equipment on account, $3,000.

c. Received cash for typing services rendered, $1,290.
d. Paid secretary's salary, $310.
e. Billed customers for typing services rendered, $2,690.
f. Paid rent expense for the month, $500.
g. Rick withdrew cash for personal use, $350.
h. Advertising expense due but unpaid, $100.

Check Figure:
Total Assets $14,820

1B-4. Jane West, owner of West Stenciling Service, has requested that you prepare from the following balances (a) an income statement for June 200X, (b) a statement of owner's equity for June, and (c) a balance sheet as of June 30, 200X.

Check Figure:
Total Assets $3,723

Cash	$2,043	Stenciling Fees	$1,098
Accounts Receivable	1,140	Advertising Expense	135
Equipment	540	Repair Expense	45
Accounts Payable	45	Travel Expense	90
J. West, Capital, June 1, 200X	3,720	Supplies Expense	270
J. West, Withdrawals	360	Rent Expense	240

1B-5. John Tobey, a retired army officer, opened Tobey's Catering Service. As his accountant, analyze the transactions and present the following information in proper form:

a. The analysis of the transactions by using the expanded accounting equation.
b. A balance sheet showing the financial position of the firm before opening on November 1, 200X.
c. An income statement for the month of November.
d. A statement of owner's equity for November.
e. A balance sheet as of November 30, 200X.

200X		
Oct.	25	John Tobey invested $17,500 in the catering business.
	27	Bought equipment on account from Munroe Co., $900.
	28	Bought equipment for cash from Ryan Co., $1,500.
	29	Paid $300 to Munroe Co. as partial payment of the October 27 transaction.
Nov.	1	Catered a business luncheon and immediately collected cash, $2,000.
	5	Paid salaries of employees, $350.
	8	Provided catering services to Northwest Community College on account, $4,500.
	10	Received from Northwest Community College $1,000 cash as partial payment of November 8 transaction.
	15	Paid telephone bill, $95.
	17	John paid his home mortgage from the company's checkbook, $650.
	20	Provided catering services and received cash, $1,800.
	25	Bought additional equipment on account, $300.
	28	Rent expense due but unpaid, $750.
	30	Paid supplies expense, $600.

Check Figure:
Total Assets,
Nov. 30 $25,005

On-the-Job Training

T-1. You have just been hired to prepare, if possible, an income statement for the year ended December 31, 200X, for Roger's Window Washing Company. The problem is that Roger Smith kept only the following records (on the back of a piece of cardboard):

FIGURE 1.10

Financial Records

Dollars in:

My investment	$ 1,200
Window cleaning	11,376
Loan from brother-in-law	4,000

Dollars out:

Salaries	$5,080
Withdrawals	6,200
Supplies expense	1,400

What I owe or they owe me

A. People who work for me but I still owe salaries to $1,800

B. Owe bank interest of $300

C. Work done but clients still owe me $2,900

D. Advertising bill due but not paid $95

Assume that Roger's Window Washing Company records all revenues when earned and all expenses when incurred.

You feel that it is part of your job to tell Roger how to organize his records better. What would you tell him?

T-2. While Jon Lune was on a business trip, he asked Abby Slowe, the bookkeeper for Lune Co., to try to complete a balance sheet for the year ended December 31, 200X. Abby, who had been on the job only two months, submitted the following:

FIGURE 1.11

Balance Sheet

LUNE CO.
FOR THE YEAR ENDED DECEMBER 31, 200X

Building	$44600 00	Accounts Payable	$127604 00
Land	72935 00	Accounts Receivable	104337 00
Notes Payable	75328 00	Auto	14268 00
Cash	10016 00	Desks	6825 00
J. Lune, Capital	?	Total Equity	$250034 00

1. Could you help Abby fix as well as complete the balance sheet?
2. What written recommendations would you make about the bookkeeper? Should she be retained?
3. Suppose that (a) Jon Lune invested an additional $20,000 in cash as well as additional desks with a value of $8,000, and (b) Lune Co. bought an auto for $6,000 that was originally marked $8,000, paying $2,000 down

and issuing a note for the balance. Could you prepare an updated balance sheet?

Financial Report Problem

Reading the Kellogg Annual Report

Go to the annual report for Kellogg Company in Appendix A. Find the balance sheet and calculate: How much did cash increase in 2004 from 2003?

Continuing Problem

Sanchez Computer Center

The following problem continues from one chapter to the next, carrying the balances of each month forward. Each chapter focuses on the learning experience of the chapter and adds information as the business grows. Forms are on page 22 of the *Study Guide and Working Papers.*

Assignment

1. Set up an expanded accounting equation spreadsheet using the following accounts:

Assets	**Liabilities**	**Owner's Equity**
Cash	Accounts Payable	Freedman, Capital
Supplies		Freedman, Withdrawal
Computer Shop		Service Revenue
Equipment		Expenses (notate type)
Office Equipment		

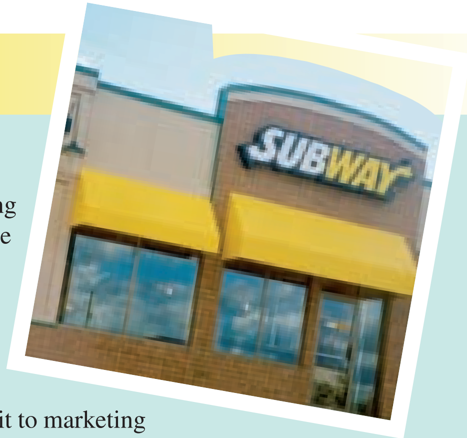
2. Analyze and record each transaction in the expanded accounting equation.

3. Prepare the financial statements ending July 31 for Sanchez Computer Center.

On July 1, 200X, Tony Freedman decided to begin his own computer service business. He named the business the Sanchez Computer Center. During the first month Tony conducted the following business transactions:

a. Invested $4,500 of his savings into the business.
b. Paid $1,200 (check # 8095) for the computer from Multi Systems, Inc.
c. Paid $600 (check # 8096) for office equipment from Office Furniture, Inc.
d. Set up a new account with Office Depot and purchased $250 in office supplies on credit.
e. Paid July rent, $400 (check # 8097).
f. Repaired a system for a customer; collected $250.
g. Collected $200 for system upgrade labor charge from a customer.
h. Electric bill due but unpaid, $85.
i. Collected $1,200 for services performed on Taylor Golf computers.
j. Withdrew $100 (check # 8098) to take his wife, Carol, out in celebration of opening the new business.

SUBWAY Case



A FRESH START

"Hey, Stan the man!" a loud voice boomed. "I never thought I'd see you making sandwiches!" Stan Hernandez stopped layering lettuce in a foot-long submarine sandwich and grinned at his old college buddy, Ron.

"Neither did I. But then again," said Stan, "I never thought I'd own a profitable business either."

That night, catching up on their lives over dinner, Stan told Ron how he became the proud owner of a Subway sandwich restaurant.

"After working like crazy at Xellent Media for five years and *finally* making it to marketing manager, then wham . . . I got laid off," said Stan. "That very day I was having my lunch at the local Subway as usual, when. . . . "

"Hmmm, wait a minute! I did notice you've lost quite a bit of weight," Ron interrupted and began to hum the bars of Subway's latest ad featuring Clay Henry, yet another hefty male who lost weight on a diet of Subway sandwiches.

"Right!" Stan quipped, "Not only was I laid off, but I was 'downsizing'! *Anyway,* I was eating a Dijon horseradish melt when I opened up an *Entrepreneur* magazine someone had left on the table—right to the headline 'Subway Named #1 Franchise in All Categories for 11th Time in 15 Years.'"

Well, to make a foot-long submarine sandwich story short, Stan realized his long-time dream of being his own boss by owning a business with a proven product and highly successful business model. When you look at Stan's restaurant, you are really seeing two businesses. Even though Stan is the sole proprietor of his business, he operates under an agreement with Subway of Milford, Connecticut. Subway supplies the business know-how and support (like training at Subway University, national advertising, and gourmet bread recipes). Stan supplies capital (his $12,500 investment) and his food preparation, management, and elbow grease. Subway and Stan operate interdependent businesses, and both rely on accounting information for their success.

Subway, in business since 1965, has grown dramatically over the years and now has more than 18,000 locations in 73 countries. It has even surpassed McDonald's in the number of locations in the United States and Canada. To manage this enormous service business requires careful control of each of its stores. At a Subway regional office, Mariah Washington, a field consultant for Stan's territory, monitors Stan's restaurant closely. In addition to making monthly visits to check whether Stan is complying with Subway's model in everything from décor to uniforms to food quality and safety, she also looks closely at Stan's weekly sales and inventory reports. When Stan's sales go up, Subway's do too, because each Subway franchisee, like Stan, pays Subway, the franchiser, a percentage of sales in the form of royalties.

Why does headquarters require accounting reports? Accounting reports give the information both Stan and the company need to make business decisions in a number of vital areas. For example:

- Before Stan could buy his Subway restaurant, the company needed to know how much cash Stan had and his assets and liabilities (such as credit card debt). Stan prepared a personal balance sheet to give them this information.
- Stan must have the right amount of supplies on hand. If he has too few, he can't make the sandwiches. If he has too many for the amount he expects to sell, items such as sandwich meats and bread dough may spoil. The inventory report tells Mariah what supplies are on hand. In combination with the sales report, it also alerts Mariah to potential red flags: If Stan is reporting that he is using far too much bread dough for the amount of sandwiches he is selling, a problem would be indicated.
- Although Subway does not require its restaurant owners to report operating costs and profit information, Subway gives them the option and most franchisees take it.

Information on profitability helps Mariah and Stan make decisions such as whether and when to remodel or buy new equipment.

So that its restaurant owners can make business decisions in a timely manner, Subway requires them to submit the weekly sales and inventory report to headquarters electronically every Thursday by 2:00 P.M. Stan has his latest report in mind as he makes a move to pay the bill for his dinner with Ron. "We had a great week. Let me get this," he says. "Thanks, Stan the Man. I'm going to keep in touch because I may just be ready for a business opportunity of my own!"

Discussion Questions

1. What makes Stan a sole proprietor?
2. Why are Stan and Subway interdependent businesses?
3. Why did Stan have to share his personal balance sheet with Subway? Do you think most interdependent businesses operate this way?
4. What does Subway learn from Stan's weekly sales and inventory reports?