Starting a Proprietorship: Changes That Affect the Accounting Equation

Chapter 1

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Chapter Overview

Chapter 1 Objectives

After studying Chapter 1, in addition to defining key terms, you will be able to:

- ✓ LO1 Describe the different users of accounting information.
- ✓ LO2 Prepare a net worth statement and explain its purpose.
- ✓ LO3 Classify accounts as assets, liabilities, or owner's equity and demonstrate their relationship in the accounting equation.
- ✓ LO4 Analyze the effects of transactions on the accounting equation.
- ✓ LO5 Distinguish between cash and on account transactions.
- ✓ LO6 Compare and contrast the types of transactions that increase and decrease owner's equity.
- ✓ LO7 Explain the difference between expenses and liabilities.

Accounting in the Real World: TOMS Shoes

Have you ever thought about owning your own business? Someone who owns, operates, and takes the risk of a business venture is called an entrepreneur. America was built on the hard work of entrepreneurs as many men and women pursued their dream of business ownership by developing new ideas and turning them into business opportunities.

The goal of a business entrepreneur is to seek economic benefit. In recent years, a new type of entrepreneur has emerged. These new entrepreneurs are driven by the same innovation and productivity, yet they seek social value rather than profits. These entrepreneurs are also agents of change. They direct their entrepreneurial energy toward seeking solutions for society's problems.

Blake Mycoskie is one of today's leading social entrepreneurs. Blake sold his driver's education business to fund a social entrepreneurial idea. While visiting Argentina, Blake noticed the number of children who had no shoes. Being shoeless limited the children's ability to attend school. Even worse, being shoeless increased the risk of developing a disabling foot disease called podoconiosis.

So Blake Mycoskie started a business called TOMS Shoes. The company name comes from the word “tomorrow” because Mycoskie wants to create a better future for impoverished children. Mycoskie's mission statement is: “I'm going to start a shoe company. For every pair of shoes that we sell, I will give a pair to someone who needs them.”

Within a short period, TOMS Shoes has given hundreds of thousands of shoes to children in the United States, Argentina, Ethiopia, and South Africa.

Critical Thinking

- How is social entrepreneurship different from nonprofit organizations?
- Identify a problem in your local community and create a solution for it by identifying a social entrepreneurship.

Assignment:
Write complete sentences to answer the above questions. Question 2 should take at least a paragraph (minimum 5 sentences) to answer. You may type of write, but I must be able to read it.

Lesson 1-1: Accounting in Action

- ✓ LO1 Describe the different users of accounting information.
- ✓ LO2 Prepare a net worth statement and explain its purpose.

Key Terms

- accounting
- accounting system
- financial statements
- net worth statement
- asset
- liability
- personal net worth
- equity
- ethics
- business ethics
- service business
- proprietorship
- business plan
- GAAP
- equities
- owner's equity
- accounting equation
- transaction
- account
- account title
- account balance
- capital account
- creditor
- revenue
- sale on account
- expense
- withdrawals

The Role of Accounting LO1

Every day, numerous business activities take place. For example, you may stop at a convenience store on the way to school to buy juice or school supplies. Have you ever wondered how many bottles of juice are sold each day? Or how much the store owner pays for rent or utilities? Or how much the store's employees are paid? Or how much the store owes to suppliers? Or would this business be a good investment?

Perhaps you have thought about starting a business by forming a local band. Do you know how to price your tickets to make a profit? Do you know the cost of renting a venue? Do you know how many tickets you will need to sell to make a profit?

All of these questions involve numbers. However, numbers alone cannot be used to make all business decisions. For instance, knowing how many bottles of orange juice were sold is important, but the data do not tell whether the store is making a profit. Data must be recorded and reported in accounting reports. Then, the information can be provided to business owners, managers, investors, and others to make business decisions and measure performance.

What is Accounting?

Whether you are going to invest in a business, work for a multimillion-dollar company, or start your own business, you will always use financial information. Accounting provides financial information to users for making decisions. The information is communicated to everyone who needs it to make good business decisions. Therefore, accounting is often referred to as the language of business.

Just like any language, it has its own terminology and rules that must be learned and practiced. Understanding this language is essential for using data to communicate effectively, making good financial decisions, and successfully operating a business. Inaccurate accounting records can make a business fail. A failure to understand accounting information can result in poor business decisions both personally and professionally.

<u>Accounting</u> is the process of planning, recording, analyzing, and interpreting financial information. The accounting process includes recording financial activities, but accounting is not the same as bookkeeping or recordkeeping. Bookkeeping is only the recording part of the accounting process. Accounting goes much further than just keeping records. Accounting involves analyzing and interpreting a business's operations to determine its financial well-being and plan its future success.

An <u>accounting system </u>s a planned process designed to compile financial data and summarize the results in accounting records and reports. Financial reports that summarize the financial condition and operations of a business are called financial statements. Business owners and managers use financial statements to make business decisions.

For many years, all accounting information was recorded using paper and ink. In today's business world, accounting software programs are widely used to record and process financial data. However, accounting software only processes data. Skill and knowledge in accounting are essential in order to effectively use the technology and correctly interpret results.

Accounting in Personal Life LO2

Accounting can be used to make personal financial decisions as well as business decisions. When buying a car, one of the first steps in the loan application is to complete a personal financial data sheet. A formal report that shows what an individual owns, what an individual owes, and the difference between the two is called a net worth statement. A net worth statement allows the person extending the loan to see the financial position of a borrower on a specific date and make a lending decision.

In order to calculate net worth, items that are owned must be identified and assigned a realistic value. Anything of value that is owned is called an asset. Examples of assets are cars, bikes, real estate, cash (including bank accounts), and jewelry. Amounts that are owed to others must be identified and assigned values. An amount owed is called a liability. Examples of liabilities include amounts owed to friends or relatives, car loans, and credit card bills.

Net worth is the total estimated value of everything owned (assets) less the total of everything owed (liabilities). The difference between personal assets and personal liabilities is called personal net worth. Net worth shows the financial value of the owner after paying all liabilities. A larger number reflects a higher net worth. In business, net worth is also called equity. Equity is the difference between assets and liabilities.

Personal Net Worth Statement

A personal net worth statement shows the assets, liabilities, and net worth of an individual. The personal net worth statement below shows a positive net worth. This means that Saida Khelchy owns more than she owes, something a lender looks upon favorably. A negative amount for net worth would reflect more debt than assets, something a lender would not favor.

Note: When statements are prepared on ruled accounting forms, it is standard practice to place double rules under the last amount on the statement to indicate that the amount is a total. Dollar signs are not used on these forms.

Ethics in Business

A business and its owner have contacts with customers, suppliers, employees, government representatives, and many others. A successful business maintains a good relationship with all of these contacts. One way to maintain a good relationship with these contacts is to conduct all business in an ethical way. The principles of right and wrong that guide an individual in making decisions are called ethics. The use of ethics in making business decisions is called business ethics.

Making ethical business decisions is a skill that can be learned. Each chapter of this textbook contains a feature on business ethics. In Part 1, you will explore a model that guides evaluation of business decisions. In Part 2, you will apply that model to make ethical business decisions. The features in Part 3 will expand your knowledge of business ethics and encourage you to continue learning about business ethics long after you have completed this accounting course.

End of Lesson Review

- ✓ LO1 Describe the different users of accounting information.
- ✓ LO2 Prepare a net worth statement and explain its purpose.

Terms Review

- accounting
- accounting system
- financial statements
- net worth statement
- asset
- liability
- personal net worth
- equity
- ethics
- business ethics

Audit Your Understanding

What is accounting?

1. Why is accounting called the language of business?
2. Describe a scenario in which you, as a nonaccountant, might use accounting.

Work Together 1-1

Megan Finder, a recent college graduate, is applying for her first credit card. The creditor has asked for a personal net worth statement. Megan has $800.00 in her checking account and owns a scooter worth $2,000.00. She owes Jaycee Auto $920.00 and River College $125.00. Complete a net worth statement for Megan Finder. Use the current date.

On Your Own 1-1

Anthony Clement is applying for a car loan. The lending institution requires a personal net worth statement. Anthony currently has $1,085.00 in cash, and his camera is worth $635.00. He also owes Kelley Electronics $83.00, and Vista Travel $305.00. Complete a net worth statement for Anthony Clement. Use the current date.

Ethics in Action: Accounting Scandals Rock the Financial World

Entering the 21st century, Enron, WorldCom, and Arthur Andersen were three of the most celebrated names in corporate America. But the actions of a few individuals forced financial mammoths Enron and WorldCom into bankruptcy. Arthur Andersen, once one of the prestigious “Big 5” accounting firms, was forced out of business. These accounting scandals caused hundreds of thousands of employees to lose their jobs. Millions of individuals lost billions of dollars in investment and retirement accounts. These scandals rocked the public's confidence in the accounting profession and the stock markets. Congress reacted by passing the Sarbanes-Oxley Act of 2002, requiring greater oversight of publicly traded companies.

Millions of individuals lost billions of dollars in investment and retirement accounts. These scandals rocked the public's confidence in the accounting profession and the stock markets. Congress reacted by passing the Sarbanes-Oxley Act of 2002, requiring greater oversight of publicly traded companies.

Instructions

Search the Internet to obtain an article that describes an accounting scandal such as the Enron, WorldCom, Adelphia, HealthSouth, or Parmalat scandals. Write a one-paragraph summary that describes what happened and the individuals involved.

May do in Word or written.   Minimum 1 paragraph (5 sentences at least) Print the article and attach it to the paragraph.   Due the day the rest of the chapter 1 working papers are due.

Lesson 1-2

- ✓ LO3 Classify accounts as assets, liabilities, or owner's equity and demonstrate their relationship in the accounting equation.

- ✓ LO4 Analyze the effects of transactions on the accounting equation.
- ✓ LO5 Distinguish between cash and on account transactions.

The Business—Delgado Web Services

Michael Delgado has designed his own personal website as well as websites for some friends. The father of one of his friends runs a plumbing business. He asked Michael if he could design a website for the plumbing business. After the website went live, the plumber's business increased by 25% in the first six months. Michael realized that he might be able to make a career from designing websites.

A business that performs an activity for a fee is called a <u>service business</u>. Examples of service businesses might include landscapers, salons, babysitters, or providers of medical services. Since Michael is the only owner of his business, the business is a proprietorship. A <u>proprietorship</u> is a business owned by one person.

The owner is legally responsible for all debts, taxes, and losses; therefore, the unlimited liability is a disadvantage. However, the owner receives all profits. The life of the business ends when the owner is no longer willing or able to continue the business. A proprietorship is sometimes referred to as a sole proprietorship.

Michael researches how to start a business. He learns that a common practice is to first write a business plan. A <u>business plan</u> is a formal written document that describes the nature of a business and how it will operate. The section of the business plan that describes the operation of the business is shown on this page. The financial part of the business plan will be developed as you study the chapters in Part 1.

Delgado Web Services: Business Plan

<u>Description:</u> Delgado Web Services will be a sole proprietorship owned by Michael Delgado. The business has no employees. The business will design, maintain, and host websites for local businesses that want an Internet presence. A key function of the service is advising customers on the kinds of information that can be included on the website and ways to increase business.

<u>Fees</u>: Fees will vary depending on the size and amount of detail on each website, as well as the consulting time spent with the customer.

<u>Suppliers</u>: Artwork and photographic services will be purchased from Mountain Graphic Artists. Equipment will be rented for a monthly fee with a service agreement. The agreement will keep the computer, server, and software up to date.

<u>Marketing</u>: The business has business cards and a promotional brochure. Local businesses that could benefit from having an Internet presence have been identified. The marketing plan includes testimonials about existing websites the owner has already designed.

Accounting Standards and Rules

The standards and rules that accountants follow while recording and reporting financial activities are commonly referred to as generally accepted accounting principles or GAAP. Pronounced as “gap,” GAAP helps ensure that all companies follow the same set of guidelines and practices when reporting financial data. Following GAAP principles and concepts ensures consistent reporting.

An example of a GAAP concept is Unit of Measurement, in which business activities are stated in numbers that have common values—that is, using a common unit of measurement. In the United States, business activities are recorded in dollars. Using the unit of measurement concept, the financial reports of businesses can be clearly stated and understood in numbers that have comparable values. [CONCEPT: Unit of Measurement] Delgado Web Services will record all business activities using dollars as the unit of measurement.

Accounting concepts are described throughout this textbook. When an application of a concept first occurs, it is explained. When additional applications occur, a concept reference, such as [CONCEPT: Business Entity], is used to indicate an application of a specific accounting concept. A brief description of each accounting concept used in this text is also provided on the Century 21 Accounting website at www.C21accounting.com .

Since Delgado Web Services is a new business, Michael must design the accounting system that will be used to keep the accounting records. Michael must be careful to keep these accounting records separate from his own personal financial records. For example, Michael owns a car for personal use. However, the financial records for Delgado Web Services must not include information about Michael's car or other personal belongings. The accounting concept Business Entity is applied when a business's financial information is recorded and reported separately from the owner's personal financial information. [CONCEPT: Business Entity]

Delgado Web Services will be used throughout Part 1 to illustrate the accounting concepts and procedures for a service business organized as a proprietorship.

Delgado Web Services will own items such as cash and supplies that will be used to conduct daily operations. Anything of value that is owned is known as an asset. Assets have value because they can be used either to acquire other assets or to operate a business. For example, Delgado Web Services will use cash to buy supplies for the business. Delgado Web Services will then use the asset bought, supplies, to operate the web design service business.

Financial rights to the assets of a business are called equities. A business has two types of equities. (1) Equity of those to whom money is owed. For example, Delgado Web Services may buy some supplies and agree to pay for the supplies at a later date. The business from which supplies are bought will have a right to some of Delgado Web Services' assets until the business pays for the supplies.

An amount owed by a business is known as a liability. (2) Equity of the owner. Michael Delgado owns Delgado Web Services and invests in the assets of the business. Therefore, he has the right to decide how the assets will be used. The amount remaining after the value of all liabilities is subtracted from the value of all assets is called owner’s equity.

The relationship among assets, liabilities, and owner's equity can be written as an equation. The equation showing the relationship among assets, liabilities, and owner's equity is called the accounting equation. The accounting equation is most often stated as:

Assets = Liabilities + Owner’s Equity

The accounting equation must always be in balance. The total of the amounts on the left side must always equal the total of the amounts on the right side.

Receiving Cash LO4

Any time a business spends money, receives money, or owes money, it engages in a business activity. Whenever a business activity takes place, amounts in the accounting equation change. Accountants call any business activity that changes assets, liabilities, or owner's equity a transaction. For example, paying cash for supplies is a transaction. After each transaction, the accounting equation must always remain in balance.

Received Cash Investment from Owner

In the accounting equation above, the Beginning Balances line shows zero balances for assets, liabilities, and owner's equity. The values are zero because the business has not yet been started. To establish his new business, Michael invests $2,000.00 of personal money in his company. Delgado Web Services will only be concerned about the effect of this transaction on Delgado Web Services' accounting records, not on Michael's personal records. [CONCEPT: Business Entity]

Transaction 1. January 2. Received cash from owner as an investment, $2,000.00.

In the accounting equation shown above, the asset Cash is increased by $2,000.00, the amount of cash received by the business. A record that summarizes all the transactions pertaining to a single item in the accounting equation is called an account. The name given to an account is called an account title. Therefore, Cash is the account that summarizes all of the assets that are cash. Cash can include a bank checking account, savings accounts, and actual cash on hand that belongs to the business.

In the accounting equation above, the asset, Cash, is increased by $2,000.00. This increase is on the left side of the equation. The difference between the increases and decreases in an account is called the account balance. Before the owner's investment, the account balance of Cash was zero. After the owner's investment, the account balance of Cash is $2,000.00.

An account used to summarize the owner's equity in a business is called a capital account. The capital account is an owner's equity account. In the accounting equation shown above, the owner's equity account, Michael Delgado, Capital, is increased by $2,000.00. This increase is on the right side of the accounting equation. Before the owner's investment, the account balance of Michael Delgado, Capital was zero. After the owner's investment, the account balance of Michael Delgado, Capital is $2,000.00.

As a result of receiving cash, the accounting equation has changed. However, both sides changed by the same amount. The $2,000.00 increase on the left side of the equation equals the $2,000.00 increase on the right side of the equation. Therefore, the accounting equation is still in balance.

REMEMBER:

The left side of the accounting equation (assets) must always equal the right side (liabilities plus owner's equity).

Paying Cash

Paid Cash for Supplies

Delgado Web Services needs supplies to operate the business. Michael Delgado uses some of the business's cash to buy supplies.

Transaction 2. January 2. Paid cash for supplies, $165.00

In this transaction, two asset accounts are changed. One asset, Cash, has been exchanged for another asset, Supplies. Supplies are considered an asset because they are of value until they are used. The asset account, Cash, is decreased by $165.00, the amount of cash paid out. This decrease is on the left side of the accounting equation. The asset account, Supplies, is increased by $165.00, the amount of supplies bought. This increase is also on the left side of the accounting equation.

For this transaction, two asset accounts are changed. The two changes are both on the left side of the equation. When changes are made on only one side of the equation, the equation must still be in balance. Therefore, if one account is increased, another account on the same side of the equation must be decreased. After this transaction, the new account balance of Cash is $1,835.00. The new account balance of Supplies is $165.00. The sum of the amounts on the left side is $2,000.00 (Cash $1,835.00 + Supplies $165.00). The amount on the right side remains at $2,000.00. Therefore, the accounting equation is still in balance.

After this transaction, the new account balance of Cash is $1,835.00. The new account balance of Supplies is $165.00. The sum of the amounts on the left side is $2,000.00 (Cash $1,835.00 + Supplies $165.00). The amount on the right side remains at $2,000.00. Therefore, the accounting equation is still in balance.

Paid Cash for Insurance

Delgado Web Services has business insurance that protects the business from losses due to accidents that might destroy the leased equipment or business records and contracts. Whenever a business buys insurance, the coverage is paid for in advance. Insurance premiums are an asset because they have value until they expire. Delgado Web Services pays a $900.00 insurance premium for insurance protection.

Transaction 3. January 3. Paid cash for insurance, $900.00

This payment gives Delgado Web Services insurance coverage for the length of the policy. Because insurance premiums are paid in advance, they are referred to as prepaid. The premiums (payments) are recorded in an asset account titled Prepaid Insurance.

This transaction is very much like the previous one in that two assets are changed. One asset, Cash, has been exchanged for another asset, Prepaid Insurance. The asset account, Cash, is decreased by $900.00, the amount of cash paid out. The asset account, Prepaid Insurance, is increased by $900.00, the amount of insurance bought.

After this transaction, the new account balance of Cash is $935.00. The new account balance of Prepaid Insurance is $900.00. The sum of the amounts on the left side is $2,000.00 (Cash, $935.00 + Supplies, $165.00 + Prepaid Insurance, $900.00). The amount on the right side remains at $2,000.00. Therefore, the accounting equation is still in balance.

Transactions on Account LO5

Bought Supplies on Account

Delgado Web Services needs to buy additional supplies. The supplies are obtained from Canyon Office Supplies. Rather than paying with cash, Delgado Web Services arranges to buy with credit and pay at the end of the month. It is a common practice to buy items and pay for them at a future date, which is referred to as buying on account. Buying on account is an arrangement made between two businesses that allows a business to buy now and pay later. Buying on account is not the same as buying with a major credit card.

Transaction 4. January 5. Bought supplies on account from Canyon Office Supplies, $220.00

In this transaction, one asset and one liability are changed. The asset account, Supplies, is increased by $220.00, the amount of supplies bought. A person or business to whom a liability is owed is called a creditor. Delgado Web Services now owes Canyon Office Supplies $220.00. This means that Canyon Office Supplies has a claim against Delgado Web Services' assets until the debt is paid.

- Therefore, Canyon Office Supplies could legally force Delgado Web Services to pay with some of its assets. The word “payable” refers to a liability that promises a future payment. The liability account titled Accounts Payable—Canyon Office Supplies is increased by $220.00, the amount owed for the supplies.

After this transaction, the new account balance of Supplies is $385.00. The new account balance of Accounts Payable—Canyon Office Supplies is $220.00. The sum of the amounts on the left side is $2,220.00 (Cash, $935.00 + Supplies, $385.00 + Prepaid Insurance, $900.00). The sum of the amounts on the right side is also $2,220.00 (Accounts Payable—Canyon Office Supplies, $220.00 + Michael Delgado, Capital, $2.000.00). Therefore, the accounting equation is still in balance.

Paid Cash on Account

Canyon Office Supplies has allowed Delgado Web Services to buy on account. However, since it is a new business, Canyon Office Supplies has requested that Delgado Web Services send a check for $100.00 immediately. Delgado Web Services will pay the remaining portion of this liability at a later date.

Transaction 5. January 9. Paid cash on account to Canyon Office Supplies, $100.00

In this transaction, one asset and one liability are changed. The asset account, Cash, is decreased by $100.00, the amount of cash paid out. After this payment, Delgado Web Services owes less money to Canyon Office Supplies. Therefore, the liability account, Accounts Payable—Canyon Office Supplies, is decreased by $100.00, the amount paid on account.

After this transaction, the new account balance of Cash is $835.00. The new account balance of Accounts Payable—Canyon Office Supplies is $120.00. The sum of the amounts on the left side of the accounting equation is $2,120.00 (Cash, $835.00 + Supplies, $385.00 + Prepaid Insurance, $900.00). The sum of the amounts on the right side of the accounting equation is also $2,120.00 (Accounts Payable—Canyon Office Supplies, $120.00 + Michael Delgado, Capital, $2,000.00). Therefore, the accounting equation is still in balance.

End of Lesson Review

- ✓ LO3 Classify accounts as assets, liabilities, or owner's equity and demonstrate their relationship in the accounting equation.
- ✓ LO4 Analyze the effects of transactions on the accounting equation.
- ✓ LO5 Distinguish between cash and on account transactions.

Terms Review

- service business
- proprietorship
- business plan
- GAAP
- equities
- owner's equity
- accounting equation
- transaction
- account
- account title
- account balance
- capital account
- creditor

Audit Your Understanding

Give two examples of service businesses in your area.

1. What must be done if a transaction increases the left side of the equation?
2. How can a transaction affect only one side of the equation?
3. What does the term on account mean?

Work Together 1-2

Determining how transactions change an accounting equation

- ❑ Write the answers to the following problem in the Working Papers. Your instructor will guide you through the following example.
- ❑ For each transaction, place a plus sign (+) in the appropriate column if the account classification asset, liability, or owner's equity is increased. Place a minus sign (–) in the appropriate column if the account classification is decreased.

Transactions:

1. Bought supplies on account.
2. Received cash from owner as an investment.
3. Paid cash for insurance.
4. Paid cash on account.

On Your Own 1-2

Determining how transactions change an accounting equation

- ❑ Write the answers to the following problem in the Working Papers. Work this problem independently.
- ❑ Place a plus sign (+) in the appropriate column if the classification is increased. Place a minus sign (–) in the appropriate column if the classification is decreased.

Transactions:

1. Received cash from owner as an investment.
2. Bought supplies on account.
3. Paid cash for supplies.
4. Paid cash for insurance.
5. Paid cash on account.

Financial Literacy: Watch Your Money Grow—The Rule of 72

One of the best ways to make money is to let money make more money. An amount paid for the use of money for a period of time is called interest. Money deposited in certain kinds of bank accounts increases when the bank pays interest on the deposit. Bank deposits are further increased with compound interest. Compound interest is interest paid on an original amount deposited in a bank plus any interest that has been paid. In other words, the original money deposited earns interest, and then the interest earns additional interest.

The "Rule of 72" is a simple way to see the power of compound interest. This formula calculates how long it will take an original investment to double its value at a given interest rate when left alone in an interest-bearing account.

When 72 is divided by the interest rate, the answer is the number of years it will take to double the money. This formula assumes that no additional deposits are made. The Rule of 72 illustrates the advantage of saving early. For example, if $500 is deposited in a bank account that earns 6% interest, it will take 12 years to double the $500. The calculation is 72 ÷ 6 = 12 years.

Activities

- Rachel dreams of starting her own business. She will need a $6,000 investment to start; however, she has saved only $3,000. The bank pays a 4% interest rate that is compounded annually. How many years will it take for Rachel's money to double?
- Rachel would like to open her business in two years. What percent interest would Rachel need to receive to double her money in two years?
- Apply the Rule of 72 to debt. If Rachel's credit card charges 18% interest, and she makes no payments, how long will it take for Rachel's debt to double?

Careers in Accounting

Many high school students consider a career in accounting. However, not many understand the variety of positions that are available in the field of accounting or the differences in the duties performed. The range of positions also comes with a range of educational and experience requirements and a corresponding range of compensation.

Many of the accounting-related job titles in a company can be arranged in a hierarchy based on educational requirements and average salary. A typical hierarchy is given below.

The higher the position on the chart, the higher the level of education and experience required for the position and the higher the level of compensation. For example, at the top of the chart, a CEO (Chief Executive Officer) and a CFO (Chief Financial Officer) would typically earn higher salaries than positions further down on the chart in the same company.

There are many accounting fields that are not related to any one company. These include auditor, forensic accountant, government accountant, and accountants in education. Each of these areas has its own education and experience requirements.

Salary Range: Salaries in the broad field of accounting range from $35,000 to over $100,000.

Qualifications: Educational requirements range from a high school accounting course to a four-year degree and higher. Special certifications can be acquired, which usually increase the salary received.
Occupational Outlook: The projected growth in accounting positions varies, but many areas of accounting are expected to grow by up to 19% by 2020.
Source: O*Net Online (http://www.onetonline.org).

Think Like an Accountant: Budgeting the Business Plan

Neil Logan came to your office with the idea of starting a web hosting service. Having previously worked in a similar company located in another state, he believes there is a need for a local web hosting business in your city. He believes this business would enable him to quit his $50,000-a-year job and “be his own boss.”

After providing you with expense estimates, Neil stated, “I believe I can effectively service 20 clients. Each site would require about 75 hours a year to design, including periodic upgrades. This service would be billed to clients at $40 per hour. Then I would also receive a $30 monthly hosting fee.”

EXCEL (use TLA CH01)

Provide Neil with answers to the following questions:

1. Based on Neil's estimates, would you suggest he quit his job to start the business?
2. Determine to the nearest dollar what hourly billing rate he would need to charge to replace his current salary.
3. What if the market will not support a higher billing rate? Can Neil achieve his goal by obtaining more customers?
4. Can you think of a change in the worksheet that could make your analysis easier?

Lesson 1-3

- ✓ LO6 Compare and contrast the types of transactions that increase and decrease owner's equity.
- ✓ LO7 Explain the difference between expenses and liabilities.

Transactions Affecting Owner's Equity LO6

Received Cash from Sales

An increase in equity resulting from the sale of goods or services is called <u>revenue</u>. When cash is received from a sale, the total amount of both assets and owner's equity is increased.

Transaction 6. January 10. Received cash from sales, $1,100.00.

Sold Services on Account

Just as Canyon Office Supplies allowed Delgado Web Services to buy on account, Delgado Web Services will allow its customers, Main Street Services and Valley Landscaping, to buy services and pay later. A sale for which payment will be received at a later date is called a <u>sales on account</u>.

Regardless of when payment is made, the revenue should be recorded at the time of the sale. The accounting principle Realization of Revenue is applied when revenue is recorded at the time goods or services are sold. [CONCEPT: Realization of Revenue]

When Delgado Web Services receives cash for services performed, the asset account, Cash, is increased by the amount of cash received, $1,100.00. This increase is on the left side of the equation. The owner's equity account, Michael Delgado, Capital, is also increased by $1,100.00. This increase is on the right side of the equation. After this transaction is recorded, the equation is still in balance.

Transaction 7. January 12. Sold services on account to Main Street Services, $500.00.

When Delgado Web Services sells services on account, it expects to receive payment in the future. Therefore, the asset account titled Accounts Receivable—Main Street Services, is increased by $500.00, the amount that will be received. This increase is on the left side of the equation. The owner's equity account, Michael Delgado, Capital, is also increased by $500.00 on the right side of the equation. The equation is still in balance.

Expense Transactions LO7

Paid Cash for Expenses

Transaction 8. January 12. Paid cash for communications bill for cellphone and Internet service, $80.00.

Unlike a liability, which is an amount that is owed, the cost of goods or services used to operate a business is called an expense.

Telephone and Internet service, rent, advertising, and utilities are common expense transactions. When cash is paid for expenses, the business has less cash. Therefore, the asset account Cash is decreased. Expenses decrease owner's equity. Therefore, the owner's equity account Michael Delgado, Capital is also decreased by the same amount.

The asset account, Cash, is decreased by $80.00, the amount of cash paid out. This decrease is on the left side of the equation. The owner's equity account Michael Delgado, Capital is also decreased by $80.00. This decrease is on the right side of the equation. After this transaction is recorded, the equation is still in balance.

All expense transactions affect the accounting equation in the same way as Transaction 8.

Transaction 9. January 13. Paid cash for equipment rental, $400.00

This expense transaction is also shown in the accounting equation. The asset account Cash is decreased by $400.00. The owner's equity account Michael Delgado, Capital is also decreased by $400.00. After the transaction is recorded, the accounting equation is still in balance.

FYI

Sometimes people confuse expenses with liabilities. Remember, an expense is a cost as a result of doing business. A liability is debt owed by the business

Other Cash Transactions

Received Cash on Account

Transaction 10. January 16. Received cash on account from Main Street Services, $200.00

When a business receives cash from a customer for a prior sale on account, the transaction increases the cash account balance and decreases the accounts receivable balance. The asset, Cash, increases because cash is received. The asset Accounts Receivable—Main Street Services decreases because the amount is no longer owed.

The asset account Cash is increased by $200.00. This increase is on the left side of the equation. The asset account Accounts Receivable—Main Street Services is decreased by $200.00. This decrease is also on the left side of the equation. After this transaction is recorded, the equation is still in balance.

Paid Cash to Owner for Personal Use

Assets taken from the business for the owner's personal use are called withdrawals. A withdrawal decreases owner's equity. An owner may withdraw any kind of asset, but usually an owner withdraws cash. Therefore, the account balance of Cash decreases.

Transaction 11. January 16. Michael Delgado withdrew equity in the form of cash, $350.00

The asset account Cash is decreased by $350.00. This decrease is on the left side of the accounting equation. The owner's equity account, Michael Delgado, Capital, is also decreased by $350.00. This decrease is on the right side of the equation. After this transaction is recorded, the equation is still in balance.

A decrease in owner's equity because of a withdrawal is not a result of the normal operations of a business. Therefore, a withdrawal is not considered an expense.

Summary of Changes in Owner's Equity

After recording the beginning investment used to start Delgado Web Services, the total owner's equity was $2,000.00, the investment by the owner, Michael Delgado. Since that initial investment, five additional transactions that changed owner's equity have been recorded in the accounting equation.

These transactions increased owner's equity by $770.00, from $2,000.00 to $2,770.00. Transaction 10, cash received on account, is not listed because it affects two accounts that are both on the left side of the accounting equation and had no impact on owner's equity. Owner's equity was not affected because the increase in owner's equity was recognized when the sale was made, not when payment was received.

End of Lesson Review

- ✓ LO6 Compare and contrast the types of transactions that increase and decrease owner's equity.
- ✓ LO7 Explain the difference between expenses and liabilities.

Terms Review

- revenue
- sale on account
- expense
- withdrawals

Audit Your Understanding

1. How is owner's equity affected when cash is received from sales?
2. How is owner's equity affected when services are sold on account?
3. How is owner's equity affected when cash is paid for expenses?

Work Together 1-3

Determining how transactions change an accounting equation

Write the answers to the following problem in the Working Papers. Your instructor will guide you through the following example.

Place a plus sign (+) in the appropriate column if the account is increased. Place a minus sign (–) in the appropriate column if the account is decreased.

Transactions:

1. Received cash from sales.
2. Sold services on account to Harmon Co.
3. Paid cash for cell phone bill.
4. Received cash on account from Harmon Co.
5. Owner withdrew equity in the form of cash.

On Your Own 1-3

Determining how transactions change an accounting equation

Write the answers to the following problem in the Working Papers. Work this problem independently.

Place a plus sign (+) in the appropriate column if the account is increased. Place a minus sign (–) in the appropriate column if the account is decreased.

Transactions:

1. Sold services on account to Bethany Center.
2. Received cash from sales.
3. Received cash on account from Bethany Center.
4. Owner withdrew equity in the form of cash.
5. Paid cash for rent.

Why Accounting?: Olympics—The Cost of Getting There

Accounting is often called the language of business. The knowledge of accounting is useful in many non-accounting positions. This Why Accounting feature will show you how accounting information is used in a variety of settings. It will focus on the 16 career clusters identified by the States' Career Clusters Initiative, 2010.

During the 2010 Winter Olympics in Vancouver, British Columbia, one of the major logistic challenges was planning how to move people. Crowds of 1.2 million spectators, 6,800 athletes, and over 10,000 media representatives were expected. All these people had to be moved around the city and Olympic venues. The locations of the events were separated by 75 miles, north to south. While all those people were moving between locations, the restaurants, stores, gas stations, and hotels providing goods and services to the visitors also had to be restocked with supplies.

Critical Thinking

1. What other costs would be included in the cost of the Olympics?
2. What other logistics would have to be planned for the Olympics?

A Look at Accounting Software

Setting Up a New Company in the Company Setup Window

See packet for print out of info

Chapter Summary

Accounting is a language used to communicate financial information so that individuals can make informed personal and business decisions. Financial information is communicated by using a planned accounting system to record, analyze, and interpret financial information.

In this chapter, you have learned that the accounting equation is stated as: Assets = Liabilities + Owner's Equity. This equation must remain in balance at all times. This means that the left side of the equation (assets) must always equal the right side of the equation (liabilities + owner's equity). As transactions occur, they are analyzed to demonstrate their effect on the accounting equation while keeping it balanced.

Explore Accounting

What is GAAP?
GAAP, or Generally Accepted Accounting Principles, defines the standards and rules that accountants follow when reporting financial activities in the United States. Important business decisions are based on these financial data. GAAP principles provide consistency in reporting so companies can be

compared. For example, Brad is evaluating whether to invest in Hewlett-Packard or Dell Inc. He compares financial information from both companies. Since both companies follow GAAP, Brad is assured that the financial data being evaluated are generated consistently. Therefore, he can make a better business decision.

Many different organizations have contributed to the rules over the years; however, since 1973, the Financial Accounting Standards Board (FASB) has been granted the authority by the Securities and Exchange Commission (SEC) to determine GAAP. GAAP has been the uniformity standard for U.S. companies. However, as many as 100 other countries follow another set of accounting rules and standards called International Financial Reporting Standards (IFRS). IFRS are set by the International Accounting Standards Board (IASB). The SEC has recognized that global business opportunities and international competition present the need for a single set of accounting standards.

Instructions

Describe other situations in which consistency in standards helps to make informed comparisons and decisions.