Chapter 2 • Analyzing Business Transactions

TEACHING OBJECTIVES

2-1. Record in equation form the financial effects of a business transaction.
2-2. Define, identify, and understand the relationship between asset, liability, and owner's equity accounts.
2-3. Analyze the effects of business transactions on a firm's assets, liabilities, and owner's equity and record these effects in accounting equation form.
2-4. Prepare an Income Statement.
2-5. Prepare a Statement of Owner's Equity and a Balance Sheet.
2-6. Define the accounting terms new to this chapter.

SECTIONS

1. **Property and Financial Interest**
2. **The Accounting Equation and Financial Statements**

CHAPTER OVERVIEW/ LEARNING OBJECTIVES

Learning Link: Chapter 1 introduced accounting by (1) defining accounting, (2) describing accounting career opportunities, and (3) identifying users of financial information. Chapter 2 illustrates basic accounting procedures by analyzing business transactions of a sole proprietorship in a service business.

2-1. This chapter records in equation form the financial effects of a business's transactions.

2-2. This chapter introduces and defines assets, liabilities and owner equity accounts. It evaluates the relationship between the accounts in equation form.

2-3. The chapter analyzes the effects of business transactions on a firm's assets, liabilities, and owner's equity, and records the effects of transactions using the accounting equation.

2-4. This chapter introduces the *Income Statement*. The *Income Statement* summarizes changes in owner's equity that result from revenue and expenses. The difference between revenue and expenses is the net income or net loss of the business for the period.

2-5. The *Statement of Changes in Owner's Equity* and a *Balance Sheet* are discussed. Changes in owner's equity for the period are summarized on the Statement of Owner's Equity.

2-6. The *Balance Sheet* shows assets, liabilities, and owner's equity on a given date.

Chapter Opener: Thinking Critically

At the beginning of the chapter, there is a short paragraph about Southwest Airlines. Let's read this together. . .

Ask students "How does Southwest keep track of all of these transactions so that it can continue to run its airline profitability?"

Answer--- The individuals in charge of keeping track of these transactions at Southwest as well as in other companies, are known as accountants. When recording the transactions, accountants are required to follow a set of rules and regulations known as GAAP. For every financial transaction that Southwest has, their accountants determine the accounts that were affected and then they record, report, and then analyze these transactions. By doing so they can, at a specific point in time and over a stipulated period, be able to assess the company's financial performance including profitability of the airline, assets owned by the company, and of course the amount owed to creditors and owners.

<u>Section 1.</u> PROPERTY AND FINANCIAL INTEREST

Beginning with Analysis

<u>Ask students</u>, "What happens when you buy a pair of jeans and pay cash?"**---The total cost of jeans they *own* increases, and the amount of cash they have decreases.**

<u>Ask students</u>, "What happens when you buy a pair of jeans with your credit card?"**—The total they *own* increases, and the amount of money they *owe* increases.**

- Point out that most business transactions have at least two effects.

<u>Objective 2-1</u>

♦ <u>Starting a Business</u>

- Explain that the equation, *property = financial interest*, is the basis for transaction analysis.

♦ <u>DESCRIBE THESE ANALYSIS STEPS:</u>

1. Explain to students that analysis (determining whether a financial event, like a purchase, sale, payment, or receipt is a business transaction) is the first step of the recording process.

2. The equation must always be in balance.

♦ <u>Purchasing Equipment for Cash</u>

- **<u>Remind students</u>** that, when recording the effects of transactions in equation form, the value of property acquired by a business is offset by any claim against the property (rights to proceeds from a sale of property).

- Emphasize that a claim is never asset specific. That is, assets are thought of as being a pool of items.

♦ **Purchasing Equipment on Credit**

- Define ***Accounts Payable***. (Amounts that a business must pay in the future.)

- Explain that purchasing an asset on credit:
  1. Increases the asset—the *Property side* of the equation.
  2. Increases the amount owed by the business—the Financial *Interest side* of the equation.

- Point out that the equation must always remain in balance.

♦ **Purchasing Supplies**

- Explain that this transaction :
  1. Increases the asset, *Supplies.*
  2. Decreases the asset, *Cash.*

- Point out that the equation remains in balance.

♦ **Paying A Creditor**

- Explain that paying a creditor involves:
  1. A decrease in the amount owed by the business—the *Financial interest* side of the equation.
  2. A decrease in cash—the *Property side* of the equation.

- Point out that the equation remains in balance.

♦ **Renting Facilities**

- Point out that the rent in this transaction is paid in advance.

- Explain that the right to occupy the facility is considered a form of property.

- Explain that this transaction:
  1. Increases the asset, *Prepaid Rent*.
  2. Decreases the asset, *Cash*.

- Point out that the equation remains in balance.

Objective 2-2

Assets, Liabilities, and Owner's Equity

Say to your students, "Suppose you want to establish a Catering Service business. What items will you need to start the business?"
--List these on the board.

Then ask students, "How will you acquire these items?" List the responses on the board.

♦ Explain to students that everything listed will be categorized as an asset or a liability. The difference is owner's equity.

♦ Have students categorize the items.

Objective 2-3

Section 2. THE ACCOUNTING EQUATION AND FINANCIAL STATEMENTS

The Fundamental Accounting Equation

Write the accounting equation on the board, then

- **Explain to students** that accountants show the relationship between assets, liabilities, and owner's equity in an equation.

- Assets are on the left and liabilities and owner's equity (claims against the assets), are on the right.

- The two sides of the equation must always balance.

- Emphasize that assets are things that an individual or a business owns that have value.

Ask students to give you examples of assets. As they yell them out, write the assets under *Assets* in the accounting equation. Do the same thing with examples of *Liabilities*.

♦ Earning Revenue and Incurring Expenses

- Explain that revenue is the inflow of assets (cash or accounts receivable) as a result of the sale of goods or services.

- Explain that expenses are the costs associated with earning revenue.

- In the beginning, students might get confused by the terms expense and liability.

- Point out that an expense is something that was used up and can actually create a liability if it is not paid off in cash. A liability is a debt owned by the business and usually ends with the word "payable"—Accounts Payable is a good example.

♦ Selling Services for Cash

- Explain that this transaction:
  1. Increases the asset, *Cash.*
  2. Increases the revenue.
- Point out that the equation remains in balance.

- Point out that revenues are recorded in a separate column under owner's equity.

♦ Selling Services on Credit

Ask students, "Why can we record this transaction as revenue even though we haven't got paid yet?" **—because we have *earned* it.**

♦ Collecting Receivables

Ask students, "Why don't we record revenue when we receive this payment?" **—because we would be recording the revenue *twice*.**

♦ Paying Employees Salaries

- Point out that expenses are recorded in a separate column under owner's equity.
- Explain that expenses have the effect of decreasing owner's equity.
- Emphasize that this transaction:
  1. Decreases the asset, *Cash.*
  2. Increases the *Expenses* column which causes Owner's Equity to go down.

- Point out that the equation remains in balance.

♦ Paying Utilities Expense

- Explain that this transaction:
  1. Decreases the asset, *Cash.*

2. Increases the Expenses column which causes Owner's Equity to go down.

- Point out that the equation remains in balance.

♦ **<u>Effects of Owner's Withdrawals</u>**

- Explain that the funds taken from the business are for the owner's *personal use* and <u>not</u> an expense of the business, but a decrease in owner's equity.

- In accounting, owner's equity is the amount remaining after the value of all liabilities is subtracted from the value of all assets. That is, it is the owner's right to the financial interest in the business.

Point out to students the ***Summary of Transactions Figure 2-2 in the text.***

- After recording all of these transactions, the accounting equation still balances.

<u>Objective 2-4</u>

The Income Statement

<u>Explain to students</u> that the *<u>Income Statement</u>* is the *first* in a series of three reports that together, provide a business owner with all of the business's financial information.

- Point out that the income statement details revenues and expenses. It reports whether the business had a "net income" or a "net loss."

<u>Ask students</u>, "When would a business report a *net loss*?" **(When expenses are greater than revenues.)**

- Explain that the heading of the Income Statement includes the appropriate three-line heading:

Who— Name of the company **What**— Name of the financial statement **When**—Period of time covered

Objective 2-5

Statement of Owner's Equity and the Balance Sheet

The *Statement of Owner's Equity* reports the *changes* that occurred in the owner's financial interest during the reporting period.

- It would include:
  1. Investments
  2. Net income or *net loss* of the business
  3. Any withdrawals the owner made

- Point out the three-line heading.

- Emphasize the importance of including the *beginning* capital balance and the *ending* capital balance.

The Balance Sheet shows:

- Point out that the Balance Sheet contains information about assets, liabilities, and the balance in the owner's equity account.
- It points out the equality of the Accounting Equation.

Ask students, "What is the difference in the heading of the statement?" **—the date line.**

- Explain that The Income Statement and the Statement of Owner's Equity are a *movie* covering a period of time but the Balance Sheet is a *snapshot* at a specific moment.

The Importance of Financial Statements

Ask students, "Where could I find information about whether a firm is making a profit?"—(**The Income Statement**).

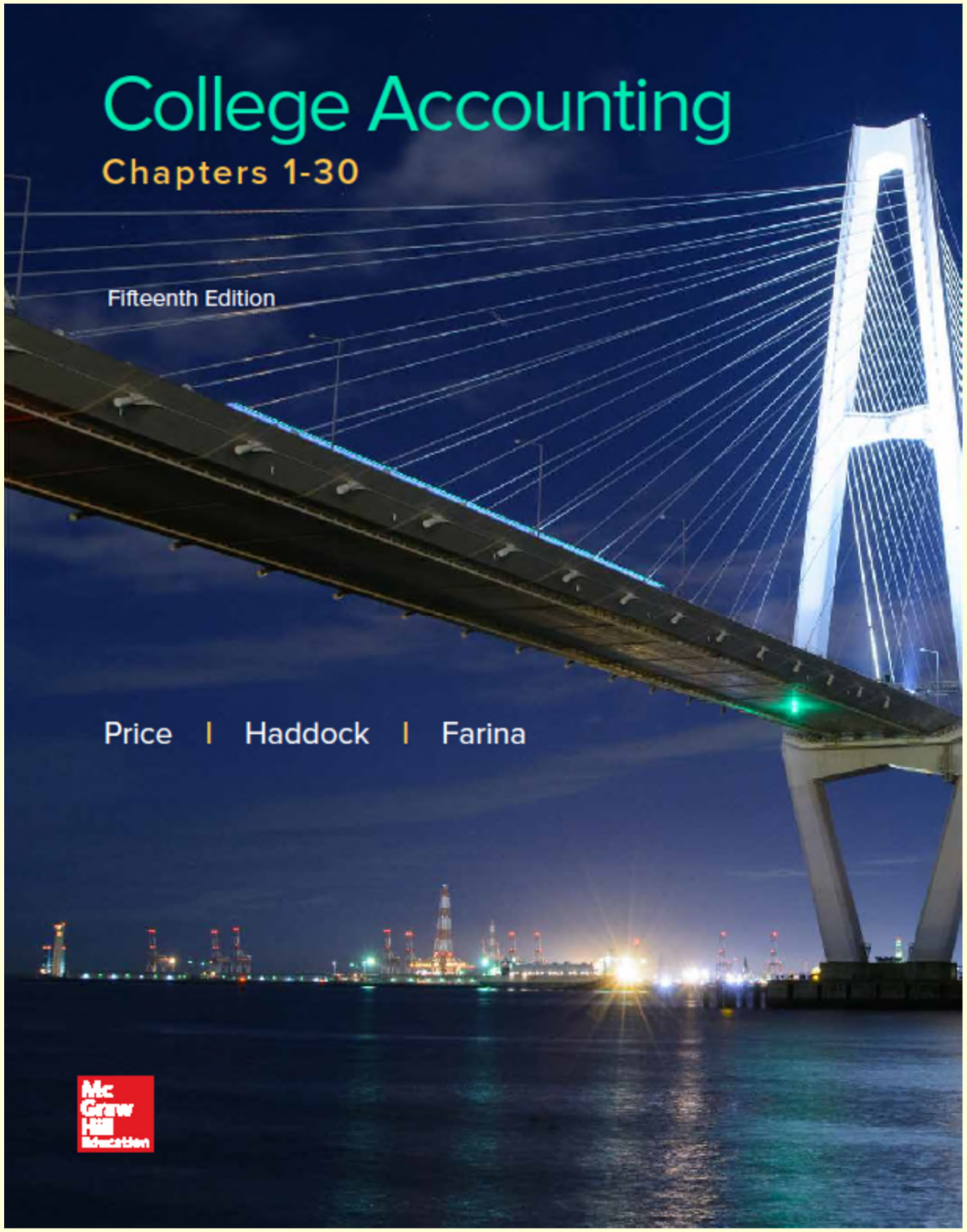
Ask students, "Which statement contains information about the assets owned or amounts owed by the business?"—(**The Balance Sheet**).

Ask students, "Which statement would provide information about how much the owner invested or withdrew during the period?"—(**The Statement of Owner's Equity**).

Financial statements and other records are necessary so that business-people can make good decisions. . .

Managerial Implications:
Ask students, "If you were buying a business, what would *you* look for in the company's financial statements?"
Answer—Answers will vary. Students should mention total assets and the type of assets, the liabilities, the business would be responsible for, and whether the business is making a profit.

- Point out the sequence/order in which the financial statements must be prepared:
  1st—income statement
  2nd—statement of owner's equity
  3rd—balance sheet


College Accounting
Chapters 1-30
Fifteenth Edition
Price | Haddock | Farina
Mc Graw Hill Education

Chapter 2
Analyzing Business Transactions

by
Price, Haddock and Farina

Chapter 2 Learning Objectives

SECTION 1: Property and Financial Interests

2-1 Record in equation form the financial effects of a business transaction.

2-2 Define, identify, and understand the relationship between asset, liability, and owner's equity accounts.

SECTION 2: The Accounting Equation and Financial Statements

2-3 Analyze the effects of business transactions on a firm's assets, liabilities, and owner's equity and record these effects in accounting equation form.

2-4 Prepare an income statement.

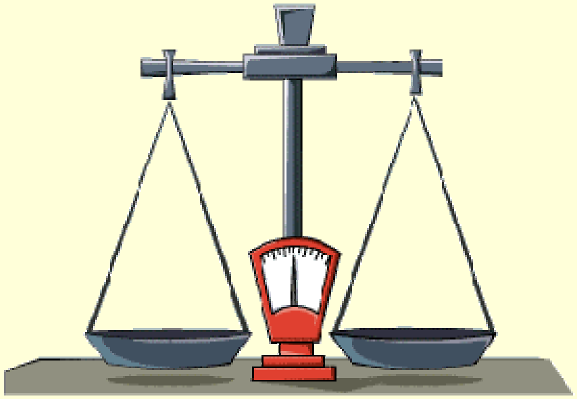
2-5 Prepare a statement of owner's equity and a balance sheet.

2-6 Define the accounting terms new to this chapter.

Meet Eli's Consulting Services

- **Eli's Consulting Services is a firm that provides a wide range of accounting and consulting services.**
- **Trayton Eli, CPA is the sole proprietor of the firm.**
- **Carlos Valdez is the office manager of the firm.**
- **Every month the firm bills clients for the services provided that month.**
- **Customers can also pay in cash when the services are provided.**

Steps to analyze the effect of a business transaction



1. Describe the financial event.
   - Identify the property.
   - Identify who owns the property.
   - Determine the amount of increase or decrease.

2. Make sure the equation is in balance.

Property (asset) = Financial Interest (creditors and owners)

Section 1: Property and Financial Interests

Learning Objective

2-1: Record in equation form the financial effects of a business transaction.

Business Transaction

Trayton Eli withdrew $100,000 from personal savings and deposited it in a new checking account in the name of Eli's Consulting Services.

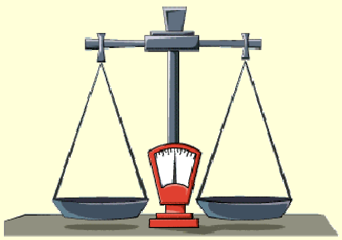
Analysis:

(a) The business received $100,000 of property in the form of cash.

(a) Eli has a $100,000 financial interest in the business.

The owner invested cash into the business

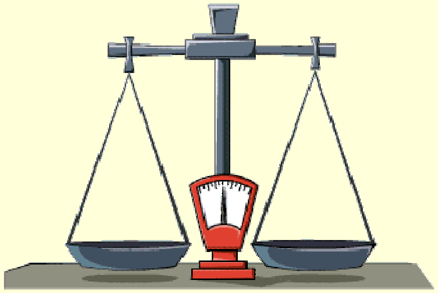
	Property	=	Financial Interest
	Cash	=	Trayton Eli, Capital
(a) Invested cash	+$100,000		
(a) Increased equity			+$100,000
New balances	$100,000	=	$100,000



Trayton Eli now has $100,000 equity in Eli's Consulting Services.

The company buys equipment for $5,000 cash

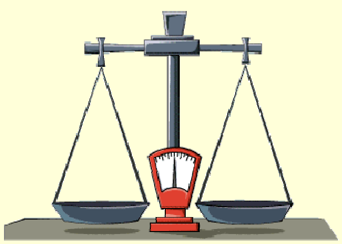
Property				=	Financial Interest
	Cash	+	Equipment	=	Trayton Ell, Capital
Previous balances	$100,000			=	$100,000
(b) Purchased equipment		+	**$5,000**		
(b) Paid cash	**−5,000**				
New balances	$95,000	+	$5,000	=	$100,000



$100,000 = $100,000

The company buys $6,000 of equipment on account (on credit)

	Property			=	Financial Interest		
	Cash	+	Equipment	=	Accounts Payable	+	Trayton Ell, Capital
Previous balances	$95,000	+	$ 5,000	=			$100,000
(c) Purchased equip.		+	**6,000**	=			
(c) Incurred debt					**+$6,000**		
New balances	$95,000	+	$11,000	=	$6,000	+	$100,000



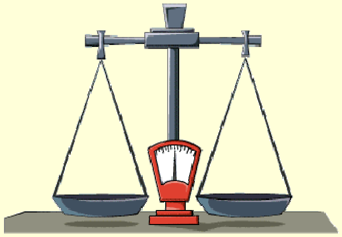
$106,000 = $106,000

Notice the new claim against the firm’s property – the creditor’s claim of $6,000.

The firm purchases supplies for $1,500 cash

	Property					=	Financial Interest		
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Trayton Ell, Capital
Previous balances	$95,000			+	$11,000	=	$6,000	+	$100,000
(d) Purchased supplies		+	**$1,500**						
(d) Paid cash	**–$1,500**								
New balances	$93,500	+	$1,500	+	$11,000	=	$6,000	+	$100,000

$106,000 = $106,000



The firm makes a payment of $2,500 on account

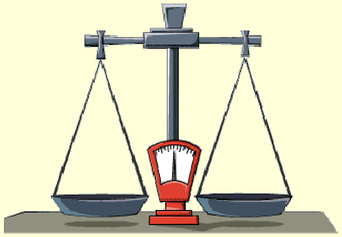
Property					=	Financial Interest		
Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Trayton Ell, Capital
$93,500	+	$1,500	+	$11,000	=	$6,000	+	$100,000
−$ 2,500								
						−$2,500		
$91,000	+	$1,500	+	$11,000	=	$3,500	+	$100,000

$103,500 = $103,500

The firm makes a payment of $8,000 rent in advance

Property							=	Financial Interest		
Cash	+	Supplies	+	Prepaid Rent	+	Equipment	=	Accounts Payable	+	Trayton Ell, Capital
$91,000	+	$1,500			+	$11,000	=	$3,500	+	$100,000
−$8,000										
				+$8,000						
$83,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000

$103,500 = $103,500



Section 1: Property and Financial Interests

Learning Objective

2-2: Define, identify, and understand the relationship between asset, liability, and owner's equity accounts.

Assets, Liabilities, and Owner's Equity

QUESTION:

What are assets?

ANSWER:

Assets are property owned by a business.

Liabilities and Equity

QUESTION:

What are liabilities?

ANSWER:

Liabilities are debts or obligations of a business

QUESTION:

What is owner's equity?

ANSWER:

Owner's equity is the term used by sole proprietorships. It is the financial interest of an owner of a business. It is also called proprietorship or net worth.

The Balance Sheet

QUESTION:

What is a Balance Sheet?

ANSWER:

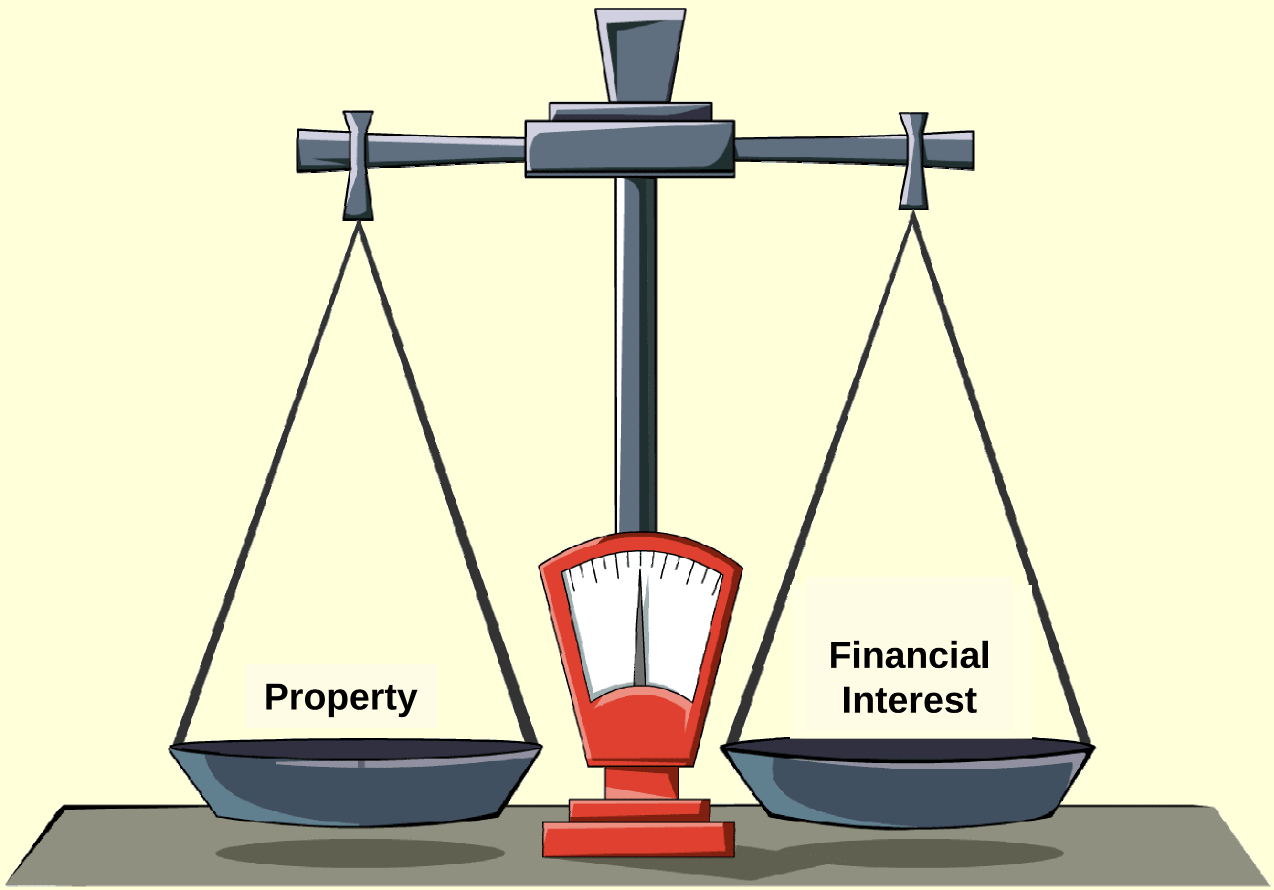
A balance sheet is a formal report of the financial position of a business on a certain date. It reports the assets, liabilities, and owner's equity of the business

The Balance Sheet

Eli's Consulting Services
Balance Sheet
November 30, 2019

Assets		Liabilities	
Cash	83 0 0 0 00	Accounts Payable	3 5 0 0 00
Supplies	1 5 0 0 00		
Prepaid Rent	8 0 0 0 00	Owner's Equity	
Equipment	11 0 0 0 00	Trayton Eli, Capital	100 0 0 0 00
Total Assets	103 5 0 0 00	Total Liabilities and Owner's Equity	103 5 0 0 00

- **Assets – the amount and types of property owned by the business**
- **Liabilities – the amount owed to the creditors**
- **Equity – the owner's interest**



Property equals Financial Interest

Section 2: The Accounting Equation and Financial Statements

Learning Objective

2- 3: Analyze the effects of business transactions on a firm's assets, liabilities, and owner's equity and record these effects in accounting equation form.

The Fundamental Accounting Equation

QUESTION:

What is the fundamental accounting equation?

ANSWER:

The fundamental accounting equation is the relationship between assets and liabilities plus owner's equity.

The Fundamental Accounting Equation

- In accounting terms the firm's assets must equal the total of its liabilities and owner's equity.
- This equality can be expressed in equation form as:

Assets = Liabilities + Owner's Equity

- The entire accounting process of analyzing, recording and reporting business transactions is based on the fundamental accounting equation.
- If any two parts of the equation are known, the third part can be determined.

Revenues

QUESTION:

What is revenue?

ANSWER:

A revenue is an inflow of money or other assets that results from the sales of goods or services or from the use of money or property. It is also called income.

Expenses

QUESTION:

What is an expense?

ANSWER:

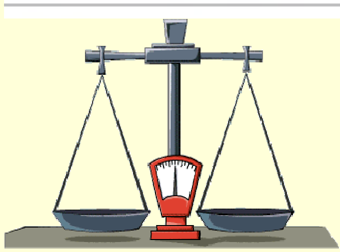
An expense is an outflow of cash, use of other assets, or incurring of a liability.

The firm receives $36,000 in cash for services provided to clients

Assets							=	Liabilities	+	Owner's Equity		
Cash	+	Supplies	+	Prepaid Rent	+	Equipment	=	Accounts Payable	+	Trayton Eli, Capital	+	Revenue
$ 83,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000		
+$36,000											+	**$36,000**
$119,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$ 36,000
$139,500								$139,500				

The company performs services on account for $11,000

Assets									=	Liab.	+	Owner's Equity		
Cash	+	Accts. Rec.	+	Supp.	+	Prepaid Rent	+	Equip.	=	Accts. Pay.	+	Trayton Eli, Capital	+	Rev.
$119,000			+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$36,000
		+$11,000												
													+	**$11,000**
$119,000	+	$11,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$47,000
$150,500										$150,500				

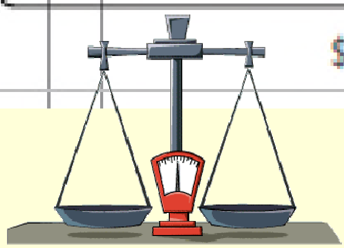


Collection of $6,000 from customers on account

Assets									=	Liab.	+	Owner's Equity		
Cash	+	Accts. Rec.	+	Supp.	+	Prepaid Rent	+	Equip.	=	Accts. Pay.	+	Trayton Eli, Capital	+	Rev.
$119,000	+	$11,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$47,000
+$6,000														
		−$6,000												
$125,000	+	$5,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$47,000
$150,500										$150,500				

The firm pays $8,000 in salaries expense for the month

Assets					=	Liab. +	Owner's Equity		
Cash	+ Accts Rec.	+ Supp.	+ Prepaid Rent	+ Equip.	=	Accts. Pay.	+ Trayton Eli, Capital	+ Rev.	− Exp.
$125,000	+ $5,000	+ $1,500	+ $8,000	+ $11,000	=	$3,500	+ $100,000	+ $47,000	
−$8,000									**+ $8,000**
$117,000	+ $5,000	+ $1,500	+ $8,000	+ $11,000	=	$3,500	+ $100,000	+ $47,000	− $8,000
$142,500						$142,500			

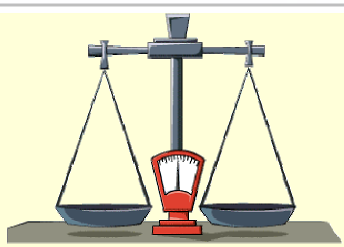


The firm pays $650 for utilities expenses

Assets									=	Liab.	+	Owner's Equity				
Cash	+	Accts. Rec.	+	Supp.	+	Prepaid Rent	+	Equip.	=	Accts. Pay.	+	T. Eli, Capital	+	Rev.	−	Exp.
$117,000	+	$5,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$47,000	−	$8,000
−$650															+	$650
$116,350	+	$5,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$47,000	−	$8,650
$141,850										$141,850						

The firm records a withdrawal by the owner of $5,000

Assets									=	Liab.	+	Owner's Equity				
Cash	+	Accts. Rec.	+	Supp.	+	Prepaid Rent	+	Equip.	=	Accts. Pay.	+	Trayton Eli, Capital	+	Rev.	−	Exp.
$116,350	+	$5,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$100,000	+	$47,000	−	$8,650
−$5,000																
											−	**$ 5,000**				
$111,350	+	$5,000	+	$1,500	+	$8,000	+	$11,000	=	$3,500	+	$95,000	+	$47,000	−	$8,650
$136,850										$136,850						



Section 2: The Accounting Equation and Financial Statements

Learning Objective

2-4: Prepare an Income Statement

QUESTION:

What is an income statement?

ANSWER:

An income statement is a formal report of business operations covering a specific period of time. It is also called a profit and loss statement or a statement of income and expenses.

The income statement has a three-line heading

The third line shows that the report covers operations over a period of time

Eli's Consulting Services
Income Statement
Month Ended December 31, 2019

Revenue		
Fees Income		$47,000.00
Expenses		
Salaries Expense	$8,000.00	
Utilities Expense	650.00	
Total Expenses		8,650.00
Net Income		$ 38,350.00

The income statement reports revenue

Eli's Consulting Services
Income Statement
Month Ended December 31, 2019

Revenue		
Fees Income		$47,000.00
Expenses		
Salaries Expense	8,000.00	
Utilities Expense	650.00	
Total Expenses		8,650.00
Net Income		$ 38,350.00

The income statement also reports expenses

Eli's Consulting Services
Income Statement
Month Ended December 31, 2019

Revenue		
Fees Income		$47,000.00
Expenses		
Salaries Expense	8,000.00	
Utilities Expense	650.00	
Total Expenses		8,650.00
Net Income		$ 38,350.00

The result is net income or net loss for the period

Eli's Consulting Services
Income Statement
Month Ended December 31, 2019

Revenue		
Fees Income		$47,000.00
Expenses		
Salaries Expense	8,000.00	
Utilities Expense	650.00	
Total Expenses		8,650.00
Net Income		$ 38,350.00

Section 2: The Accounting Equation and Financial Statements

Learning Objective

2-5: Prepare a Statement of Owner's Equity and Balance Sheet

A Statement of Owner's Equity

Eli's Consulting Services
Statement of Owner's Equity
Month Ended December 31, 2019

Trayton Eli, Capital, December 1, 2019		$100,000.00
Net Income for December	$38,350.00	
Less Withdrawals for December	5,000.00	
Increase in Capital		33,350.00
Trayton Eli, Capital, December 31, 2019		$133,350.00

The Balance Sheet

Eli’s Consulting Services
Balance Sheet
December 31, 2019

Assets		Liabilities	
Cash	111,350.00	Accounts Payable	3,500.00
Accounts Receivable	5,000.00		
Supplies	1,500.00		
Prepaid Rent	8,000.00	**Owner’s Equity**	
Equipment	11,000.00	Trayton Eli, Capital	133,350.00
Total Assets	136,850.00	Total Liabilities and Owner’s Equity	136, 850.00

- A single line shows that the amounts above it are being added or subtracted.
- A double line indicates final amounts for the column or section of a report.

The Importance of Financial Statements

- Business managers and owners use the balance sheet and the income statement to control current operations and plan for the future.

- Creditors, prospective investors, governmental agencies, and others are interested in the profits of the business and in the asset and equity structure.

Financial statements are always prepared in a specific order:

1st Income Statement

2nd Statement of Owner’s equity

3rd Balance Sheet

Financial statements :

Eli's Consulting Services
Income Statement
Month Ended December 31, 2019

Revenue		
Fees Income		47,000.00
Expenses		
Salaries Expense	8,000.00	
Utilities Expense	650.00	
Total Expenses		8,650.00
Net Income		38,350.00

Net income (or loss) is transferred to the statement of owner's equity.

Eli's Consulting Services
Statement of Owner's Equity
Month Ended December 31, 2019

Trayton Eli, Capital, December 1, 2019		100,000.00
Net Income for December	38,350.00	
Less Withdrawals for December	5,000.00	
Increase in Capital		33,350.00
Trayton Eli, Capital, December 31, 2019		133,350.00

The ending capital balance is transferred to the balance sheet.

Eli's Consulting Services
Balance Sheet
December 31, 2019

Assets		*Liabilities*	
Cash	111,350.00	*Accounts Payable*	3,500.00
Accounts Receivable	5,000.00		
Supplies	1,500.00		
Prepaid Rent	8,000.00	*Owner's Equity*	
Equipment	11,000.00	*Trayton Eli, Capital*	133,350.00
Total Assets	136,850.00	*Total Liabilities and Owner's Equity*	136,850.00

Thank You

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