weygandt
kimmel

5TH EDITION

FINANCIAL ACCOUNTING

WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS

WILEY

Financial Accounting

with International Financial Reporting Standards

Fifth Edition

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WILEY

DEDICATED TO

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From the Authors

Dear Student,

Why This Course? Remember your biology course in high school? Did you have one of those "invisible man" models (or maybe something more high-tech than that) that gave you the opportunity to look "inside" the human body? This accounting course offers something similar. To understand a business, you have to understand the financial insides of a business organization.

A financial accounting course will help you understand the essential financial components of businesses. Whether you are looking at a large multinational company like **Samsung** or **adidas** or a single-owner software consulting business or coffee shop, knowing the fundamentals of financial accounting will help you understand what is happening. As an employee, a manager, an investor, a business owner, or a director of your own personal finances—any of which roles you will have at some point in your life—you will make better decisions for having taken this course.

Why This Text? Your instructor has chosen this text for you because of our trusted reputation. We have worked hard to write a text that is engaging, timely, and accurate.

"Whether you are looking at a large multinational company like **Samsung** or **adidas** or a single-owner software consulting business or coffee shop, knowing the fundamentals of financial accounting will help you understand what is happening."

How to Succeed? We've asked many students and many instructors whether there is a secret for success in this course. The nearly unanimous answer turns out to be not much of a secret: "Do the homework." This is one course where doing is learning. The more time you spend on practicing and doing—using the various tools that this text and the Wiley online course provides—the more likely you are to learn the essential concepts, techniques, and methods of accounting.

Good luck in this course. We hope you enjoy the experience and that you put to good use throughout a lifetime of success the knowledge you obtain in this course. We are sure you will not be disappointed.

Jerry J. Weygandt
Paul D. Kimmel

Author Commitment

JERRY J. WEYGANDT, PhD, CPA, is Arthur Andersen Alumni Emeritus Professor of Accounting at the University of Wisconsin—Madison. He holds a Ph.D. in accounting from the University of Illinois. Articles by Professor Weygandt have appeared in *The Accounting Review, Journal of Accounting Research, Accounting Horizons, Journal of Accountancy*, and other academic and professional journals. These articles have examined such financial reporting issues as accounting for price-level adjustments, pensions, convertible securities, stock option contracts, and interim reports. Professor Weygandt is author of other accounting and financial reporting texts and is a member of the American Accounting Association, the American Institute of Certified Public Accountants, and the Wisconsin Society of Certified Public Accountants. He has served on numerous committees of the American Accounting Association and as a member of the editorial board of the Accounting Review; he also has served as President and Secretary-Treasurer of the American Accounting Association. In addition, he has been actively involved with the American Institute of Certified Public Accountants and has been a member of the Accounting Standards Executive Committee (AcSEC) of that organization. He has served on the FASB task force that examined the reporting issues related to accounting for income taxes and served as a trustee of the Financial Accounting Foundation. Professor Weygandt has received the Chancellor's Award for Excellence in Teaching and the Beta Gamma Sigma Dean's Teaching Award. He is on the board of directors of M & I Bank of Southern Wisconsin. He is the recipient of the Wisconsin Institute of CPA's Outstanding Educator's Award and the Lifetime Achievement Award. In 2001 he received the American Accounting Association's Outstanding Educator Award.

PAUL D. KIMMEL, PhD, CPA, received his bachelor's degree from the University of Minnesota and his doctorate in accounting from the University of Wisconsin. He was an Associate Professor at the University of Wisconsin—Milwaukee for more than 25 years and is now a Senior Lecturer at the University of Wisconsin—Madison. He has public accounting experience with Deloitte & Touche (Minneapolis). He was the recipient of the UWM School of Business Advisory Council Teaching Award and the Reggie Taite Excellence in Teaching Award, and a three-time winner of the Outstanding Teaching Assistant Award at the University of Wisconsin. He is also a recipient of the Elijah Watts Sells Award for Honorary Distinction for his results on the CPA exam. He is a member of the American Accounting Association and the Institute of Management Accountants and has published articles in *Accounting Review, Accounting Horizons, Advances in Management Accounting, Managerial Finance, Issues in Accounting Education*, and *Journal of Accounting Education*, as well as other journals. His research interests include accounting for financial instruments and innovation in accounting education.

New to This Edition: Data Analytics

The authors carefully considered how to thoughtfully and meaningfully integrate data analytics into the financial accounting course, and are pleased to provide the following data analytics resources.

Data Analytics and Decision-Making

The text provides numerous discussions on how decision-makers are increasingly relying on data analytics to make decisions using accounting information.

> Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.
>
> - **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
> - As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies.

Data Analytics in the Real World

Real-world examples that illustrate engaging situations in companies are provided throughout the text.

Data Analytics Insight **Netflix**

boumenjapet/Adobe Stock

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called "big data." And **Netflix** (USA), the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

In a recent year, Netflix planned to spend $8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production schedules, Netflix can more precisely estimate costs for future productions.

Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Based on Ritwik Kumar et. al., "Data Science and the Art of Producing Entertainment at Netflix," *The Netflix Tech Blog* (March 26, 2018).

How can "big data" improve decision-making? (Answer is available near the end of the chapter.)

Data Analytics in Action

Data Analytics in Action problems provide students with the opportunity to see how to use data analytics to help solve realistic business problems.

- **PowerBI and Tableau visualizations** accompanied by assignable questions are available with most chapters. PowerBI and Tableau visualizations allow students to interpret visualizations and think critically about data.

- **Excel-based data analytics problems** are also available for most chapters. The accompanying Excel templates provide students with a framework for solving the problem.

Data Analytics in Excel videos provide students with step-by-step guidance to perform the Excel skills they need to solve these problems.

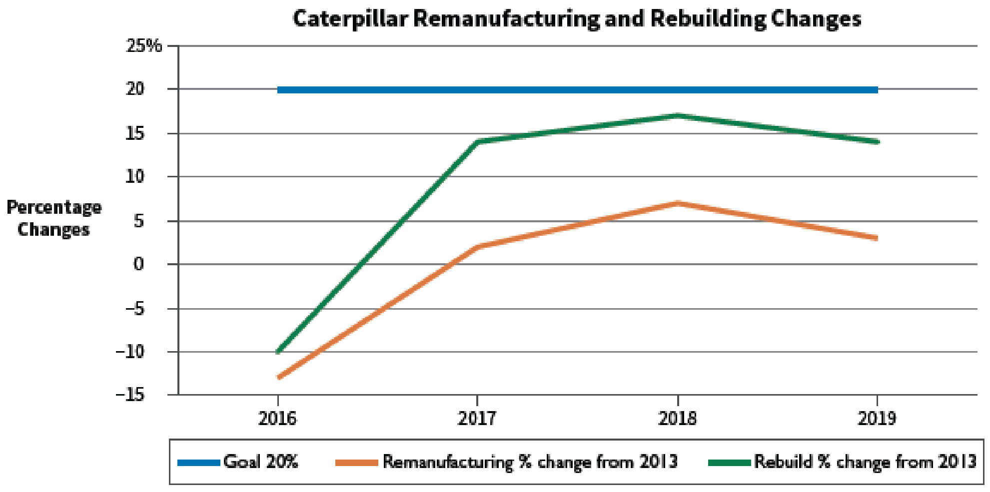
Data Analytics in Action

Using Data Visualization to Analyze Changes over Time

DA6.1 Data visualization can be used to analyze company changes over time.

Example: Recall the Feature Story "Where Is That Spare Bulldozer Blade?" presented in the chapter. One competitor to **Komatsu Ltd.** (JPN) is **Caterpillar** (USA), which continues to enhance its inventory management by improving its product sustainability in two ways. First, it is rebuilding used parts to like-new condition. Second, the company is remanufacturing usable inventory parts when customers trade-in or dispose of their used equipment. These actions not only reduce inventory costs but also enable Caterpillar to participate in the circular economy, where manufacturers take responsibility for their products at the end of the product lives. As noted in its 2019 sustainability report, Caterpillar has a goal of 20% growth in both rebuilding and remanufacturing.

Has Caterpillar reached this goal? A line chart can help you visualize the company's progress over time. What information can you obtain by examining the following chart?



Source: Data from "ESG Data Center," *Caterpillar 2019 Sustainability Report.*

The chart indicates that while Caterpillar's goal has remained at 20%, the remanufacturing and rebuilding businesses are growing. The biggest increase in the growth of rebuilding occurred from 2016 to 2017. There was a decline from 2018 to 2019 in these initiatives as Caterpillar may have reached a peak that is leveling off due to new production that is more sustainable.

For this case, you will look more closely at specific Caterpillar data regarding its end-of-life returned materials and the percentage usable for recycling. You will create and analyze a combination column and line chart to determine how Caterpillar can increase its gross profit as it relates to these end-of-life materials.

Go to the Wiley online course for complete case details and instructions.

Using Data Analytics to Compare Companies' Inventory Turnover

DA6.2 Inventory turnover shows the number of times during the period a firm sells the entire financial value of its inventory. It is advantageous to turn over inventory more quickly to reduce the risk of obsolescence and spoilage. As such, companies often have a goal of increasing inventory turnover. For this case, you will use inventory turnover data for U.S. companies **Costco**, **Walmart**, **Target**, and **Amazon** to create and analyze scatter plots, as well as to calculate days' sales in inventory, to determine which company is managing its inventory levels most effectively.

Go to the Wiley online course for complete case details and instructions.

Data Analytics Module

An **accounting-specific data analytics module** with interactive lessons, case studies, and videos is part of the Wiley online course. The module has been prepared using industry-validated content to help students develop the professional competencies needed for the changing workforce.

New to This Edition

The last few years have brought many changes to the teaching and learning environment. As a result, we scrutinized every chapter of *Financial Accounting* to make sure our text best meets the needs of today's students and instructors. The most significant changes throughout the text include:

- NEW discussion of data analytics integrated throughout the text, at an appropriate level of detail for introductory accounting students.
- NEW Data Analytics assignments at the end of selected chapters.
- MORE bulleted/numbered lists within the text discussion, to highlight key information for students.
- UPDATED fair value principle and historical cost principle to current value basis/historical cost basis per recent IFRS throughout.
- ADDED Answers to Insight box questions near the end of each chapter.

Chapter-by-Chapter Changes

Chapter 1: Accounting in Action

- NEW discussion of how financial statement users can employ data analytics to improve decision-making.
- NEW discussion on the current value basis, and updated discussion of historical cost basis, per recent IFRS.
- NEW Helpful Hint on the two concepts of income under IFRS: net income and comprehensive income.
- NEW Data Analytics Insight, on how **Netflix** uses data analytics to estimate costs for future productions.
- NEW Ethics Insight, on the financial frauds that occurred at **Toshiba**.

Chapter 2: The Recording Process

- NEW Helpful Hint, to reinforce student understanding of journals.

Chapter 3: Adjusting the Accounts

- NEW discussion, illustration, and end-of-chapter assignments of the five-step revenue recognition process.
- NEW Helpful Hint, on how adjusting entries have no effect on cash flows.
- UPDATED discussion for historical cost and current value bases.
- UPDATED Environmental, Social, and Governance (ESG) Insight on disposing of electronics safely.

Chapter 4: Completing the Accounting Cycle

- UPDATED discussion of worksheet to put its use more in context of the accounting cycle.
- NEW discussion of recent technology (robotic process automation) used in the closing process.
- UPDATED definitions of current assets and current liabilities per most recent IFRS.
- NEW Accounting Across the Organization boxes on (1) using robots and process mining for routine accounting tasks and (2) liquidity management during Covid-19.

Chapter 5: Accounting for Merchandising Operations

- NEW section, "Data Analytics and Credit Sales," on how companies use data analytics to improve business decision-making regarding their policies on credit sales, sales returns and allowances, and sales discounts.
- EXPANDED discussion of FOB shipping point/FOB destination to ensure student understanding.
- NEW Appendix 5C, "Adjusting Entries for Credit Sales with Returns and Allowances," and related EOC material.
- NEW Accounting Across the Organization box on how **Alibaba** uses personalized shopping pages to increase its e-commerce presence and revenue.
- UPDATED discussion of fair value to current value/net realizable value throughout.
- NEW Data Analytics in Action end-of-chapter problem on using data visualizations to analyze companies' profitability.

Chapter 6: Inventories

- NEW discussions on (1) write-down reversals and (2) how data analytics can benefit inventory management.
- NEW Data Analytics Insight on effectiveness of dashboards.
- NEW Accounting Across the Organization box on fashion companies' innovative methods for handling deadstock.
- UPDATED Accounting Across the Organization box ("A Big Hiccup") to include Covid-19 impacts on global automotive manufacturers.
- NEW illustration showing **Walmart**'s recent inventory disclosure, using the retail inventory method.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations to analyze companies over time and data analytics to compare companies' inventory turnover.
- NEW end-of-chapter case on inventory theft.

Chapter 7: Fraud, Internal Control, and Cash

- NEW section on how data analytics helps improve internal controls.
- UPDATED discussion of over-the-counter, electronic, and check receipts per recent technology.
- UPDATED discussion of electronic banking per recent technology.
- UPDATED discussion of cash equivalents and restricted cash per recent standards.
- NEW Anatomy of a Fraud boxes on fraud due to the missing control of segregation of duties.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations to help understand fraud and using data analytics to determine the impact of internal control activities.
- NEW end-of-chapter cases on blockchain technology and the IASB.

Chapter 8: Accounting for Receivables

- NEW section on data analytics and receivables management.
- NEW Data Analytics Insight on using data analytics to help with credit decisions and estimating uncollectible accounts.
- NEW discussion of IASB expected credit loss model, which requires that companies measure expected uncollectible accounts and record bad debt expense on all receivables, even those with a low risk of loss.
- NEW Data Analytics in Action end-of-chapter problems on using data visualization to analyze bad debts over time and using data analytics to evaluate notes receivables over time.

Chapter 9: Plant Assets, Natural Resources, and Intangible Assets

- UPDATED definition of depreciation.
- NEW Data Analytics in Action end-of-chapter problem on using data visualization to analyze assets.

Chapter 10: Current Liabilities

- NEW Accounting Across the Organization box on whether **SAP**'s growing deferred income account is a good sign or bad.
- NEW end-of-chapter case on how Covid-19 has impacted microfinancing.

Chapter 11: Non-Current Liabilities

- NEW Investor Insight on how **Volkswagen** issued debt to manage developing electric vehicles as well as Covid-19 issues, and the implications of that for the company's future.

Chapter 12: Corporations: Organization, Share Transactions, and Equity

- NEW discussion on hybrid forms of business organization.
- UPDATED discussion of statement of changes in equity, as now a required statement.
- NEW ESG Insight box on the upward trend of shareholder proposals on corporate responsibility.
- NEW Investor Insight, on how companies that pay dividends can increase investor wealth.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations to compare share prices and data analytics to compare the effect of share splits.

Chapter 13: Investments

- NEW discussions on (1) the classification and measurement of investments, (2) accounting for bonds both to hold and to sell, (3) using fair value to account for share investments of less than 20%, and (4) accounting for debt investments classified as held-for-collection and selling.
- UPDATED discussion to include the three (previously two) categories of securities.

Chapter 14: Statement of Cash Flows

- NEW Accounting Across the Organization box on how companies are moving away from hypergrowth and instead focusing on growing profits and cash flows.
- NEW Data Analytics in Action end-of-chapter problems on using data visualizations and data analytics to analyze cash flows.

Chapter 15: Financial Statement Analysis

- UPDATED to include more bulleted lists to facilitate student understanding.

Proven Pedagogical Features

In this new edition, all content has been carefully reviewed and revised to ensure maximum student understanding. At the same time, the time-tested features that have proven to be of most help to students have been retained, such as the following.

Infographic Learning

Over half of the text is visual, providing students alternative ways of learning about accounting.

ILLUSTRATION 6.9 Allocation of costs—average-cost method

Cost of Goods Available for Sale

Date	Explanation	Units	Unit Cost	Total Cost
Jan. 1	Beginning inventory	10	HK$100	HK$ 1,000
Apr. 15	Purchase	20	110	2,200
Aug. 24	Purchase	30	120	3,600
Nov. 27	Purchase	40	130	5,200
	Total	100		HK$12,000

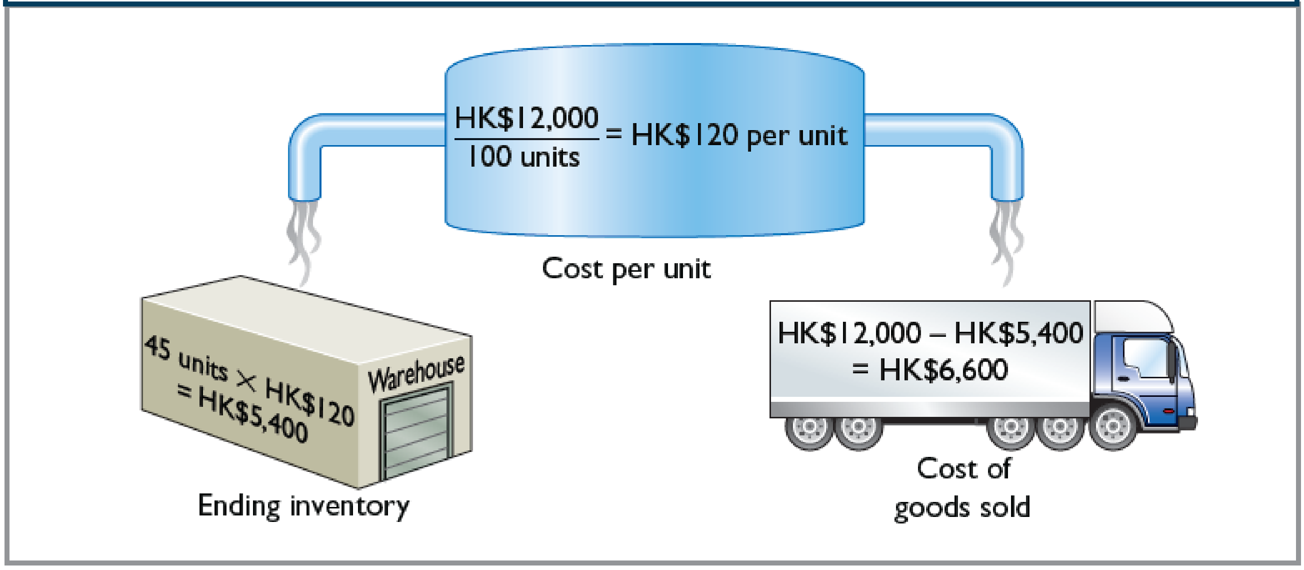
Step 1: Ending Inventory

HK$12,000 ÷ 100 = HK$120

Units	Unit Cost	Total Cost
45	HK$120	HK$5,400

Step 2: Cost of Goods Sold

Cost of goods available for sale	HK$12,000
Less: Ending inventory	5,400
Cost of goods sold	HK$ 6,600



Real-World Decision-Making

Real-world examples, which illustrate engaging situations in companies, are provided throughout the text. Answers to the critical thinking questions posed to readers within the real-world examples are now available near the end of each chapter.

Environmental, Social, and Governance Insight

Nathan Gleave/Getty Images

Got Junk?

Do you have an old computer or two in your garage? How about an old TV that needs replacing? Many people do. Approximately 163,000 computers and televisions become obsolete **each day**. Yet, in a recent year, only 11% of computers were recycled.

It is estimated that 75% of all computers ever sold are sitting in storage somewhere, waiting to be disposed of. Each of these old TVs and computers is loaded with lead, cadmium, mercury, and other toxic chemicals. If you have one of these electronic gadgets, you have a responsibility, and a probable cost, for disposing of it. Companies have the same problem, but their discarded materials may include lead paint, asbestos, and other toxic chemicals.

What accounting issue might this cause for companies? (Answer is available near the end of the chapter.)

DO IT! Exercises

DO IT! Exercises in the body of the text prompt students to stop and review key concepts. They outline the Action Plan necessary to complete the exercise as well as show a detailed solution.

ACTION PLAN

- Make adjusting entries at the end of the period to recognize revenues for services performed and for expenses incurred.
- Don't forget to make adjusting entries for accruals. Adjusting entries for accruals will increase both a statement of financial position and an income statement account.

DO IT! 3 | Adjusting Entries for Accruals

Mahindra Computer Services began operations on August 1, 2025. At the end of August 2025, management prepares monthly financial statements. The following information relates to August (amounts in thousands).

1. At August 31, the company owed its employees ₹800 in salaries and wages that will be paid on September 1.
2. On August 1, the company borrowed ₹30,000 from a local bank on a 15-year mortgage. The annual interest rate is 10%.
3. Revenue for services performed but unrecorded for August totaled ₹1,100.

Prepare the adjusting entries needed at August 31, 2025.

Solution

1. Salaries and Wages Expense	800	
Salaries and Wages Payable		800
(To record accrued salaries)		
2. Interest Expense	250	
Interest Payable		250
(To record accrued interest: ₹30,000 × 10% × $\frac{1}{12}$ = ₹250)		
3. Accounts Receivable	1,100	
Service Revenue		1,100
(To record revenue for services performed)		

Related exercise material: **BE3.9, DO IT! 3.3, E3.5, E3.6, E3.7, E3.8, E3.9, and E3.10.**

Review and Practice

Each chapter concludes with a Review and Practice section which includes a review of learning objectives, Decision Tools review, key terms glossary, practice multiple-choice questions with annotated solutions, practice brief exercises with solutions, practice exercises with solutions, and a practice problem with a solution.

Review and Practice

Practice Brief Exercises

Indicate why adjusting entries are needed.

1. **(LO 1)** The ledger of Dey Company includes the following accounts. Explain why each account may need adjustment.

a. Supplies.
b. Unearned Service Revenue.
c. Salaries and Wages Payable.
d. Interest Payable.

Solution

1. **a.** Supplies: to recognize supplies used during the period.
b. Unearned Service Revenue: to record revenue generated for services performed.
c. Salaries and Wages Payable: to recognize unpaid salaries and wages due to employees at the end of a reporting period.
d. Interest Payable: to recognize interest accrued but unpaid on notes payable.

Prepare adjusting entry for depreciation.

2. **(LO 2)** At the end of its first year, the trial balance of Denton Cleaners shows Equipment of £40,000 and zero balances in Accumulated Depreciation—Equipment and Depreciation Expense. Depreciation for the year is estimated to be £8,000. Prepare the adjusting entry for depreciation at December 31, post the adjustments to T-accounts, and indicate the statement of financial position presentation of the equipment at December 31.

Solution

2. Dec. 31	Depreciation Expense	8,000	
	Accumulated Depreciation—Equipment		8,000

Depreciation Expense

12/31	8,000		

Accum. Depreciation—Equipment

		12/31	8,000

Statement of financial position:

Equipment	£40,000	
Less: Accumulated depreciation—equipment	8,000	£32,000

Prepare adjusting entries for accruals.

3. **(LO 3)** You are asked to prepare the following accrual adjusting entries at December 31.

1. Services performed but not recorded are €4,200.
2. Utilities expenses incurred but not paid are €660.
3. Salaries and wages earned by employees of €3,000 are unpaid.

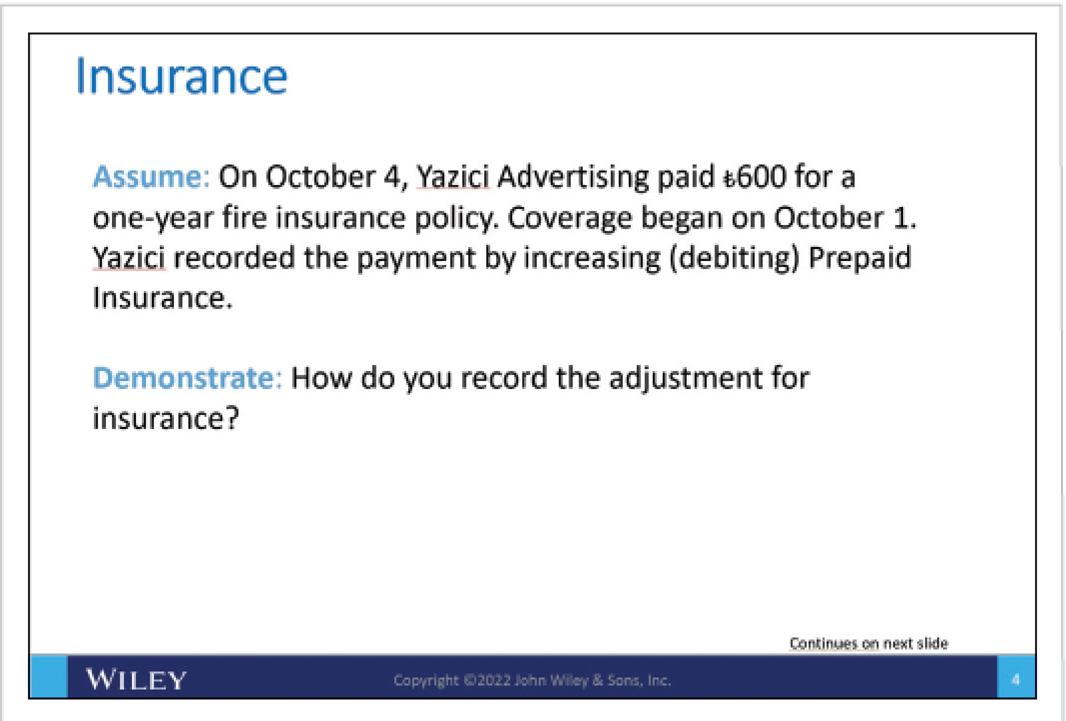
Use the following account titles: Accounts Receivable, Service Revenue, Salaries and Wages Expense, Salaries and Wages Payable, Utilities Expense, and Utilities Payable.

Engaging Digital Tools

Digital study tools in Wiley's online course include the following.

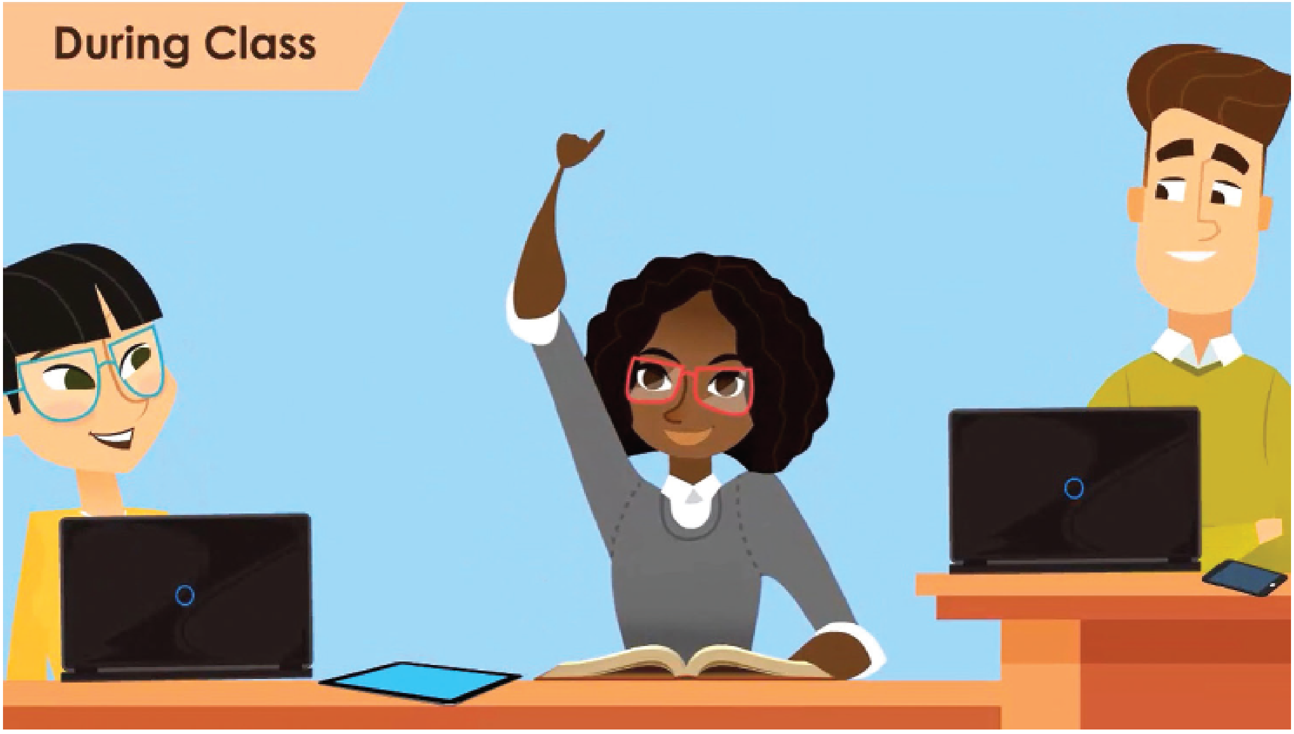
Lecture PowerPoints

Lecture PowerPoints break down each section and learning objective in the text. The slides simplify major concepts in the text, making the concepts easier to understand. They provide additional explanation for activities, images, and figures to enhance student learning.



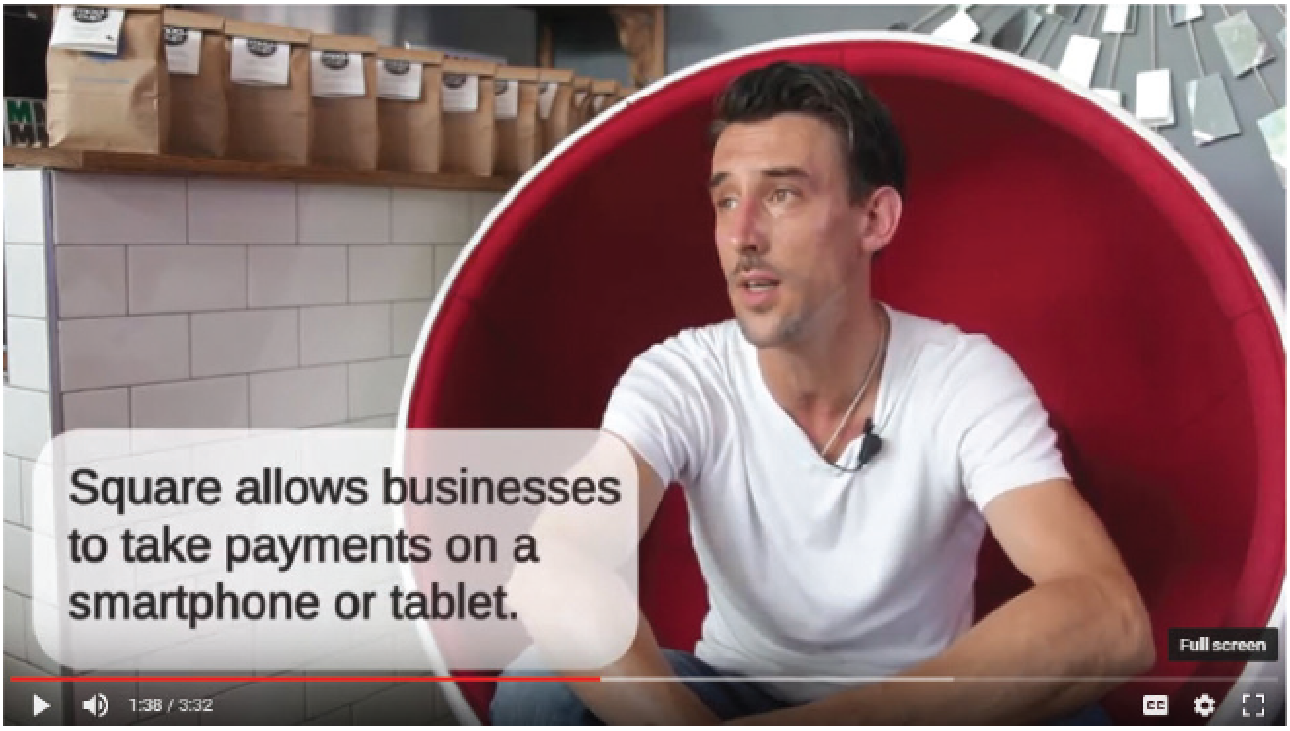
Accounting Animated Shorts

Short, animated videos engage students and simplify major concepts in the text, making the concepts easier to understand. They offer an alternative approach to understanding the written material.



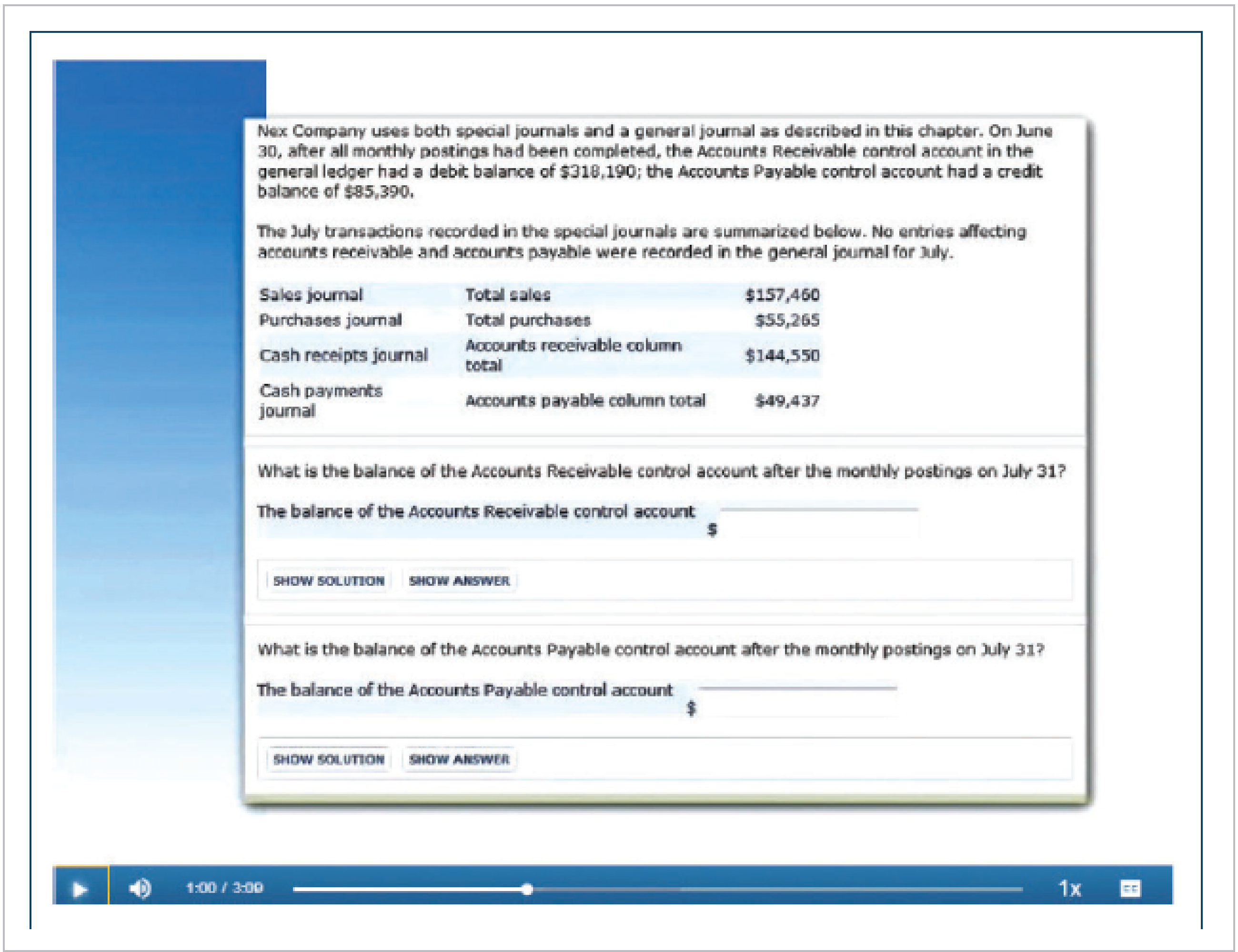
Real-World Videos

Real-world videos feature both small businesses and larger companies to help students apply content and see how business owners apply concepts from the text in the real world. Many of the videos have associated questions available to be assigned.



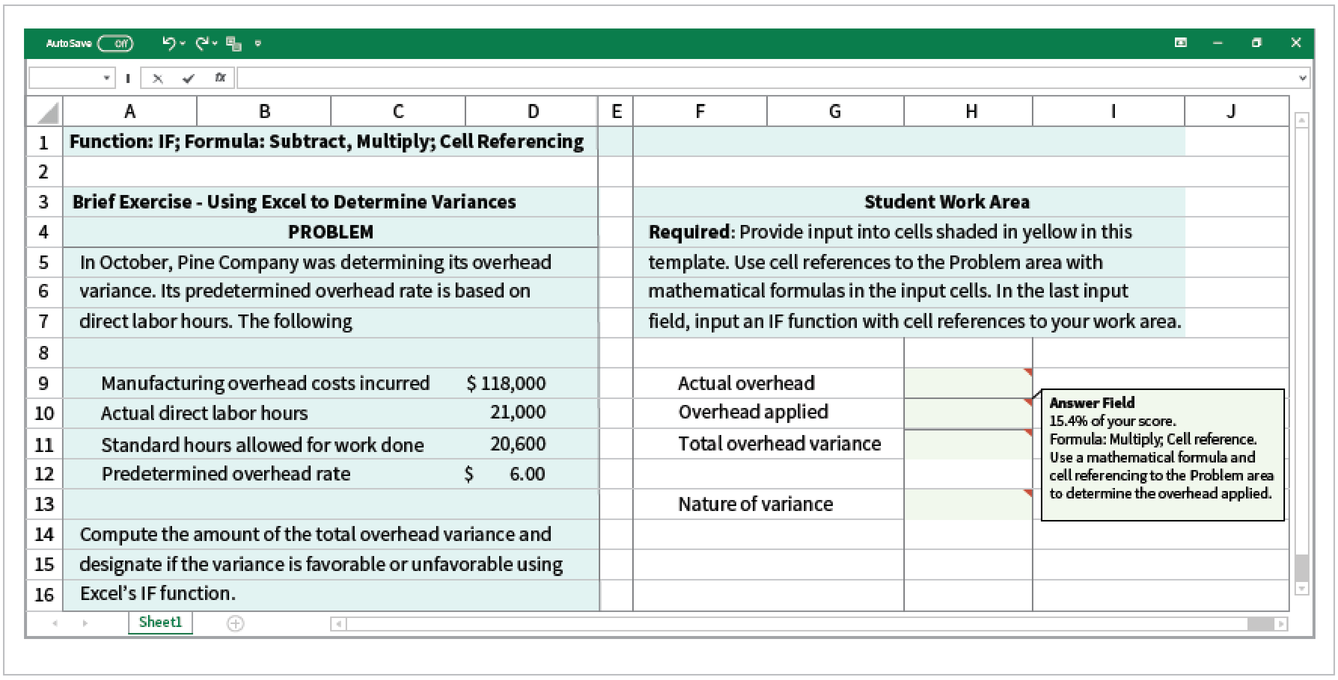
Solution Walkthrough Videos

Solution Walkthrough Videos are available as question assistance and to help students develop problem-solving techniques. These videos walk students through solutions step-by-step and are based on the most regularly assigned exercises and problems in the text.



Gradable Excel Questions

Gradable Excel questions provide students an opportunity to practice Excel skills in the context of solving accounting problems.



Other Learning Opportunities

Other learning opportunities in Wiley's online course include the following.

- **Accounting-Specific Data Analytics Module** offers interactive lessons, case studies, and videos. The module has been prepared using industry-validated content to help students develop the professional competencies needed for the changing workforce.
- **Matcha Creations** is a continuing case that spans across chapters and offers students the opportunity to see how a small business might use financial accounting to operate effectively.
- **Wiley Accounting Updates** (wileyaccountingupdates.com) provide faculty and students with weekly curated news articles and suggested discussion questions.
- **Flashcards and Crossword Puzzles** help students study and master basic vocabulary and concepts.
- **Student Practice** quickly and effectively assesses student understanding of the material they have just covered.

Thank You

Meet Our Contributor

In this new edition of *Financial Accounting*, the authors are pleased to welcome the assistance of Jack Cathey. A professor at the University of North Carolina—Charlotte, Jack assisted the authors with updating chapter content per the most recent IFRS as well as the current accounting environment. He also ensured that the company references are the most relevant and relatable to the student, focusing on well-known companies with tangible examples.

Additional Acknowledgments

Financial Accounting has benefited greatly from the input of those who have sent comments by letter or email, ancillary authors, and proofers. We greatly appreciate the constructive suggestions and innovative ideas of reviewers and the creativity and accuracy of the ancillary authors and checkers.

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Finally, we appreciate suggestions and comments from users—instructors and students alike. We welcome your thoughts and ideas about the text.

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CHAPTER 1
Accounting in Action

Erik Isakson/Tetra Images/AGE Fotostock

*The **Chapter Preview** describes the purpose of the chapter and highlights major topics.*

Chapter Preview

The following Feature Story highlights the importance of having good financial information and knowing how to use it to make effective business decisions. Whatever your pursuits or occupation, the need for financial information is inescapable. You cannot earn a living, spend money, buy on credit, make an investment, or pay taxes without receiving, using, or dispensing financial information. Good decision-making depends on good information.

*The **Feature Story** helps you picture how the chapter topic relates to the real world of accounting and business.*

Feature Story

Knowing the Numbers

Many students who take this course do not plan to be accountants. If you are in that group, you might be thinking, "If I'm not going to be an accountant, why do I need to know accounting?" In response, consider the quote from Harold Geneen, the former chairman of a major international company: "To be good at your business, you have to know the numbers—cold."

Success in any business comes back to the numbers. You will rely on them to make decisions, and managers will use them to evaluate your performance. That is true whether your job involves marketing, production, management, or information systems.

In business, accounting is the means for communicating the numbers. If you don't know how to read financial statements, you cannot really know your business.

Many companies spend significant resources teaching their employees basic accounting so that they can read financial statements and understand how their actions affect the company's financial results. Employers need managers in all areas of the company to be "financially literate."

Taking this course will go a long way to making you financially literate. In this text, you will learn how to read and prepare financial statements, and how to use basic tools to evaluate financial results.

Appendices A, B, and C of this text provide real financial statements of three companies from different countries that report using International Financial Reporting Standards (IFRS): **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN), **Nestlé SA** (CHE), and **Delfi Limited** (SGP). Throughout this text, we increase your familiarity with financial reporting by providing numerous references, questions, and exercises that encourage you to explore these financial statements. In addition, we encourage you to visit each company's website where you can view its complete annual report.

Even though these three companies are based in three different countries, they all follow IFRS. This means they all follow the same basic accounting principles. As a result, their financial statements are very similar. Therefore, by learning these basic principles as presented in this text, you will be well equipped to begin understanding the financial results of companies around the world.

*The **Chapter Outline** presents the chapter's topics and subtopics, as well as practice opportunities.*

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Identify the activities and users associated with accounting.	• Who uses accounting data • Data analytics	**DO IT! 1** Basic Concepts
LO 2 Explain the building blocks of accounting: ethics, principles, and assumptions.	• Ethics in financial reporting • Accounting standards • Measurement principles • Assumptions	**DO IT! 2** Building Blocks of Accounting
LO 3 State the accounting equation, and define its components.	• Assets • Liabilities • Equity	**DO IT! 3** Equity Effects
LO 4 Analyze the effects of business transactions on the accounting equation.	• Accounting transactions • Transaction analysis • Summary of transactions	**DO IT! 4** Tabular Analysis
LO 5 Describe the five financial statements and how they are prepared.	• Income statement • Retained earnings statement • Statement of financial position • Statement of cash flows • Comprehensive income statement	**DO IT! 5** Financial Statement Items

Go to the Review and Practice section at the end of the chapter for a targeted summary and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

1.1 Accounting Activities and Users

LEARNING OBJECTIVE 1

Identify the activities and users associated with accounting.

What consistently ranks as one of the top career opportunities in business? What frequently rates among the most popular majors on campus? Accounting.[1] Why do people choose accounting? They want to acquire the skills needed to understand what is happening financially inside an organization. Accounting is the financial information system that provides these insights. In short, to understand your organization, you have to know the numbers.

Accounting consists of three basic activities—it **identifies**, **records**, and **communicates** the economic events of an organization to interested users.

1. As a starting point to the accounting process, a company identifies the **economic events relevant to its business**. Examples of economic events are the sale of food and snacks by **Unilever** (GBR), the providing of telephone services by **Chunghwa Telecom** (TWN), and the manufacture of motor vehicles by **Tata Motors** (IND).

2. Once a company like Unilever identifies economic events, it **records** those events in order to provide a history of its financial activities. Recording consists of keeping a **systematic**, **chronological diary of events**, measured in monetary units. In recording, Unilever also classifies and summarizes economic events.
3. Finally, Unilever **communicates** the collected information to interested users by means of **accounting reports**. The most common of these reports are called **financial statements**.

***Essential terms** are printed in blue when they first appear, and are defined in the end-of-chapter **Glossary Review**.*

To make the reported financial information meaningful, Unilever reports the recorded data in a standardized way. It accumulates information resulting from similar transactions. For example, Unilever accumulates all sales transactions over a certain period of time and reports the data as one amount in the company's financial statements. Such data are said to be reported **in the aggregate**. By presenting the recorded data in the aggregate, the accounting process simplifies a multitude of transactions and makes a series of activities understandable and meaningful.

A vital element in communicating economic events is the accountant's ability to **analyze and interpret** the reported information.

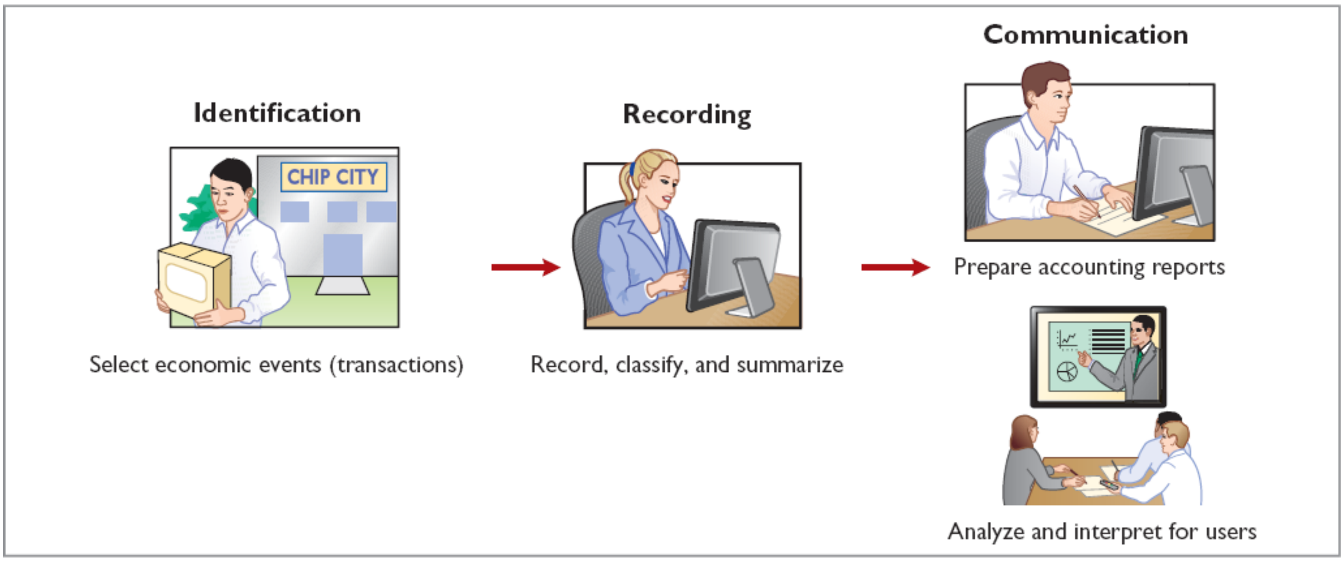
- Analysis involves use of ratios, percentages, graphs, and charts to highlight significant financial trends and relationships.
- Interpretation involves **explaining the uses, meaning, and limitations of reported data**.

Appendix A of this text shows the financial statements of **Taiwan Semiconductor Manufacturing Company (TSMC) Ltd.** (TWN). Appendix B illustrates the financial statements of **Nestlé SA** (CHE), and Appendix C includes the financial statements of **Delfi Limited** (SGP). We refer to these statements at various places throughout the text. (In addition, in the *A Look at U.S. GAAP* section at the end of each chapter, the U.S. company **Apple Inc.** is analyzed.)

At this point, these financial statements probably strike you as complex and confusing. By the end of this course, you'll be surprised at your ability to understand, analyze, and interpret them.

Illustration 1.1 summarizes the activities of the accounting process.

ILLUSTRATION 1.1 The activities of the accounting process



You should understand that the accounting process **includes** the bookkeeping function.

- **Bookkeeping** usually involves **only** the recording of economic events.
- It is therefore just one part of the accounting process.

In total, accounting involves **the entire process of identifying, recording, and communicating economic events.**[2]

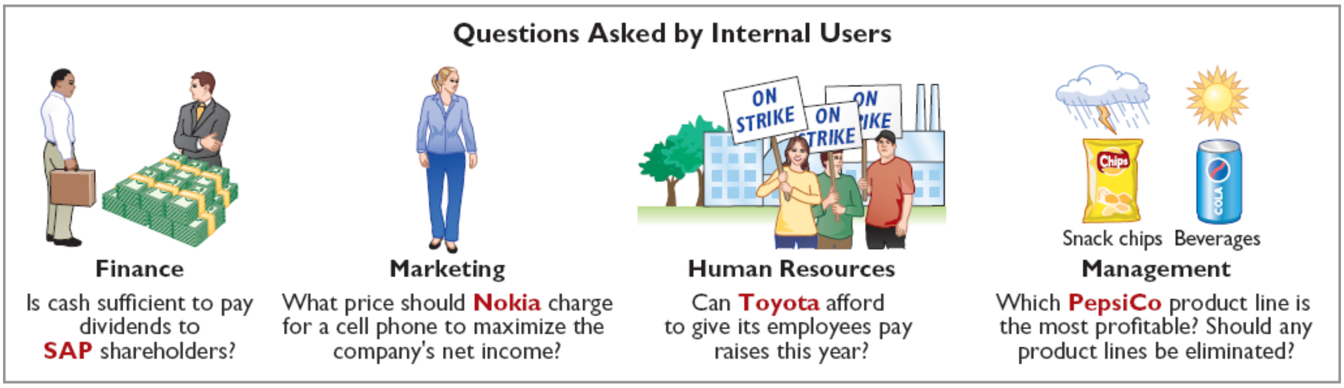
Who Uses Accounting Data

The financial information that users need depends upon the kinds of decisions they make. There are two broad groups of users of financial information: internal users and external users.

Internal Users

Internal users of accounting information are managers who plan, organize, and run the business. These include marketing managers, production supervisors, finance directors, and company officers. In running a business, internal users must answer many important questions, as shown in Illustration 1.2.

ILLUSTRATION 1.2 Questions that internal users ask



To answer these and other questions, internal users need detailed information on a timely basis. Managerial accounting provides internal reports to help users make decisions about their companies. Examples are financial comparisons of operating alternatives, projections of income from new sales campaigns, and forecasts of cash needs for the next year.

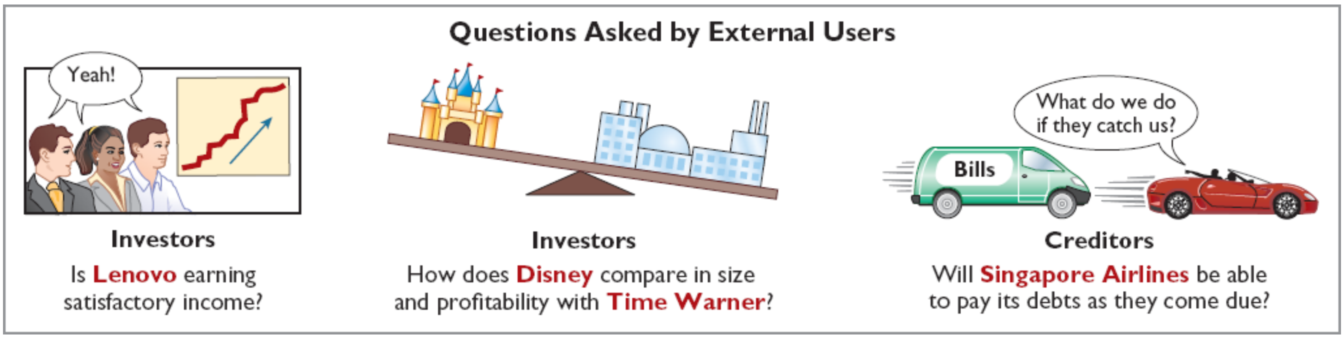
External Users

External users are individuals and organizations outside a company who want financial information about the company. The two most common types of external users are investors and creditors.

- **Investors** (owners) use accounting information to decide whether to buy, hold, or sell ownership shares of a company.
- **Creditors** (such as suppliers and bankers) use accounting information to evaluate the risks of granting credit or lending money.

Illustration 1.3 shows some questions that investors and creditors may ask.

ILLUSTRATION 1.3 Questions that external users ask



Financial accounting answers these questions. It provides economic and financial information for investors, creditors, and other external users. The information needs of external users vary considerably.

- **Taxing authorities**, such as the State Administration of Taxation in the People's Republic of China (CHN), want to know whether the company complies with tax laws.
- **Regulatory agencies**, such as the Financial Services Authority of Indonesia (IDN), want to know whether the company is operating within prescribed rules.
- **Customers** are interested in whether a company like Tesla Motors, Inc. (USA) will continue to honor product warranties and support its product lines.
- **Labor unions**, such as the Indian National Trade Union Congress (IND), want to know whether companies have the ability to pay increased wages and benefits to union members.

Data Analytics

Accounting software systems collect vast amounts of data about a company's economic events as well as its suppliers and customers. Business decision-makers take advantage of this wealth of data by using data analytics to gain insights and therefore make more informed business decisions.

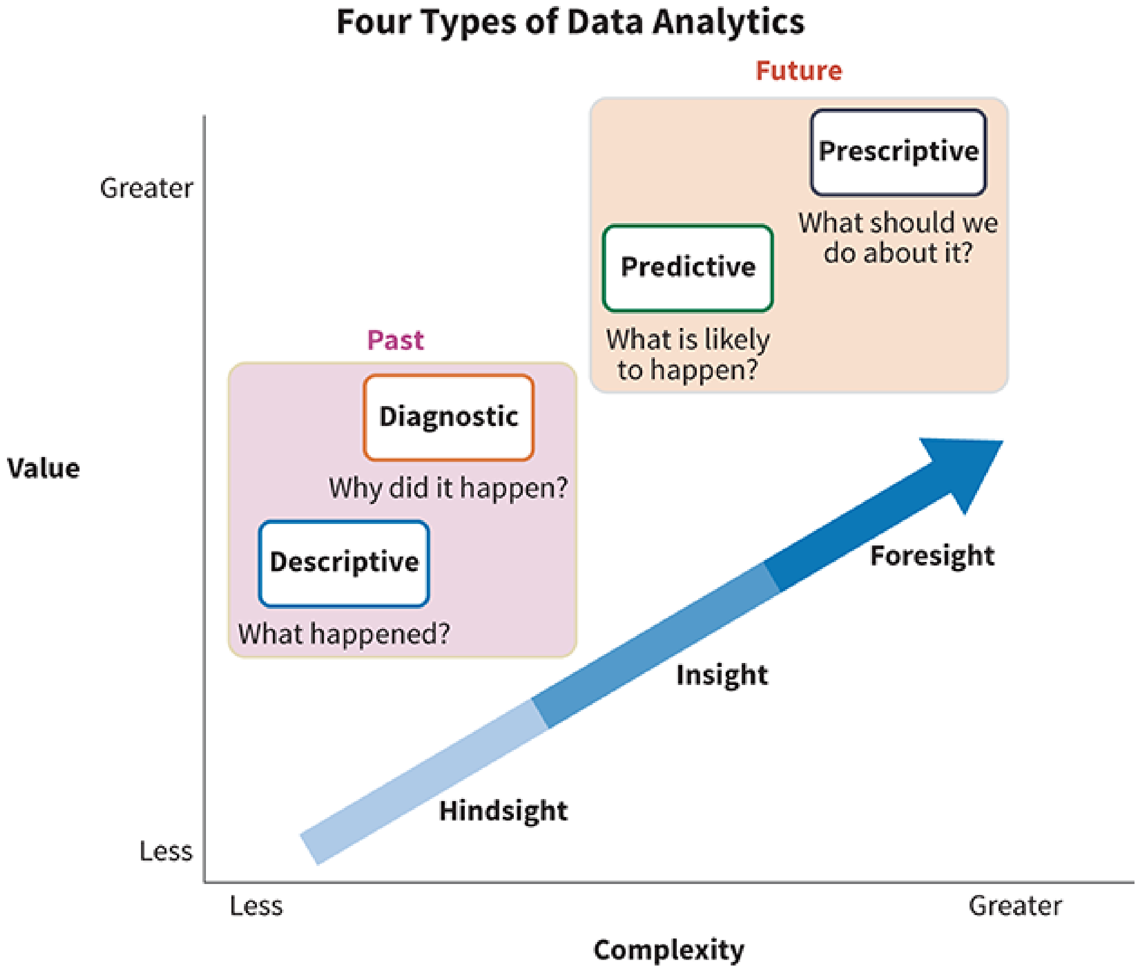
- **Data analytics** involves analyzing data, often employing both software and statistics, to draw inferences.
- As both data access and analytical software improve, the use of data analytics to support decisions is becoming increasingly common at virtually all types of companies (see **Helpful Hint**).

***Helpful Hints** further clarify concepts being discussed.*

> **HELPFUL HINT**
>
> **Throughout this text, we will highlight examples where accounting information is used to support business decisions using data analytics.**

Illustration 1.4 shows the four most common types of data analytics that help answer questions ranging from what happened and why did it happen, to what is likely to happen and what should we do about it? Analytics range from simple analysis that can be performed using spreadsheets with tools like pivot tables and graphs, to complex statistical software and even artificial intelligence. More complex analysis provides greater value to the business.

ILLUSTRATION 1.4 Four types of data analytics



***Insight** boxes provide examples of business situations from various perspectives—ethics; investor, global; environmental, social, and governance; and data analytics.*

Data Analytics Insight

Netflix

Using Data Science to Create Art

Technology provides decision-makers and problem-solvers with access to a large volume of information called "big data." And **Netflix** (USA), the world's leading subscription streaming entertainment service, is tapping into this big data as part of its efforts to ramp up its original content production.

UnSplash

In a recent year, Netflix planned to spend $8 billion on content creation. Producing content involves a blend of creativity, technology, and business decisions, all of which result in costs. And by analyzing the large amounts of data from past productions, such as filming locations and production schedules, Netflix can more precisely estimate costs for future productions.

Further, consider that the production of a TV show or film involves hundreds of tasks. Here again, Netflix uses data science, in this case to visualize where bottlenecks might occur or where opportunities might exist to increase the efficiency of the production process.

Source: Based on Ritwik Kumar et al., "Data Science and the Art of Producing Entertainment at Netflix," *The Netflix Tech Blog* (March 26, 2018).

How can "big data" improve decision-making?

Answer

*The **DO IT!** exercises ask you to put newly acquired knowledge to work. They outline the **Action Plan** necessary to complete the exercise, and they show a **Solution**.*

DO IT! 1

Basic Concepts

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and communication.
2. Bookkeeping encompasses all steps in the accounting process.
3. Accountants prepare, but do not interpret, financial reports.
4. The two most common types of external users are investors and company officers.
5. Managerial accounting activities focus on reports for internal users.

ACTION PLAN

- **Review the basic concepts discussed.**
- **Develop an understanding of the key terms used.**

Solution

Related exercise material: **DO IT! 1.1**, **E1.1**, **and E1.2**.

1.2 The Building Blocks of Accounting

LEARNING OBJECTIVE 2

Explain the building blocks of accounting: ethics, principles, and assumptions.

A doctor follows certain protocols in treating a patient's illness. An architect follows certain structural guidelines in designing a building. Similarly, an accountant follows certain standards in reporting financial information. These standards are based on specific principles and assumptions. For these standards to work, however, a fundamental business concept must be present—ethical behavior.

Ethics in Financial Reporting

People won't gamble in a casino if they think it is "rigged." Similarly, people won't invest in the securities market if they think share prices are rigged. In recent years, the financial press has been full of articles about financial scandals at **Mahindra Satyam** (IND), **Toshiba** (JPN), **Pou Sheng International** (HKG), **Siwei** (CHN), and other companies.

As the scandals came to light, mistrust of financial reporting in general grew. One article in the financial press noted that "repeated disclosures about questionable accounting practices have bruised investors' faith in the reliability of earnings reports, which in turn has sent share prices tumbling." Imagine trying to carry on a business or invest money if you could not depend on the financial statements to be honestly prepared. Information would have no credibility. There is no doubt that a sound, well-functioning economy depends on accurate and dependable financial reporting.

The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. Effective financial reporting depends on sound ethical behavior. To sensitize you to ethical situations in business and to give you practice at solving ethical dilemmas, we address ethics in a number of ways in this text:

1. A number of the *Feature Stories* and other parts of the text discuss the central importance of ethical behavior to financial reporting.
2. *Ethics Insight* boxes and marginal *Ethics Notes* highlight ethics situations and issues in actual business settings.
3. Many of the *Environmental, Social, and Governance Insight* boxes focus on ethical issues that companies face in measuring and reporting social and environmental issues.
4. At the end of the chapter, an *Ethics Case* simulates a business situation and asks you to put yourself in the position of a decision-maker in that case.

When analyzing these various ethics cases, as well as experiences in your own life, it is useful to apply the three steps outlined in **Illustration 1.5**.

ILLUSTRATION 1.5 Steps in analyzing ethics cases and situations

1. Recognize an ethical situation and the ethical issues involved.
Use your personal ethics to identify ethical situations and issues. Some businesses and professional organizations provide written codes of ethics for guidance in some business situations.

2. Identify and analyze the principal elements in the situation.
Identify the **stakeholders**—persons or groups who may be harmed or benefited. Ask the question: What are the responsibilities and obligations of the parties involved?

3. Identify the alternatives, and weigh the impact of each alternative on various stakeholders.
Select the most ethical alternative, considering all the consequences. Sometimes there will be one right answer. Other situations involve more than one right solution; these situations require an evaluation of each and a selection of the best alternative.

Ethics Insight

Toshiba

Loyalty to Your Employer Is Great, Until It Is Not

nmann77/Adobe Stock

A common attribute of Japanese employees is a culture of strong loyalty to their employer. This loyalty arises out of a common practice of lifetime employment combined with a general cultural value of respect. While strong loyalty is a positive in many respects, it can create challenges in some circumstances.

For example, **Toshiba** (JPN), like many Japanese businesses, was severely affected by a series of events in the early 2000s. First, the company, along with the rest of the world, experienced the financial crisis and subsequent global recession in 2008 and 2009. Next, in 2011, an earthquake and subsequent tsunami in northern Japan triggered a significant recession in Japan. The company experienced a 14% decline in revenue from 2007 to 2013, and a 90% decline in profits over the same period.

In response to these events, company leadership began to pressure divisional and mid-level managers to achieve unreasonable financial goals. These managers, unable to meet the unreasonably high performance expectations and influenced by a strong culture of loyalty and respect, were left with little choice but to create profits where there were none. They committed a number of financial frauds, including unreasonable estimates and improper recording of transactions with suppliers.

In 2015, when these matters came to light, it was determined that reported revenues during this period had been overstated by ¥129 million and profits for the period has been overstated by ¥477 million.

Source: Based on Dennis Caplan, Saurav Dutta, and David Marchinko, “Unmasking the Fraud at Toshiba,” *Issues in Accounting Education*, Vol. 34, No. 3 (August 2019).

What would you do if your company asked you to misreport an item?

Answer

Accounting Standards

In order to ensure high-quality financial reporting, accountants present financial statements in conformity with accounting standards that are issued by standard-setting bodies. Presently, there are two primary accounting standard-setting bodies—the **International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)**.

- More than 150 countries follow standards referred to as **International Financial Reporting Standards (IFRS)**.
- IFRSs are determined by the IASB. The IASB is headquartered in London, with its board members drawn from around the world.
- Most companies in the United States follow standards issued by the FASB, referred to as **generally accepted accounting principles (GAAP)**.

As markets become more global, it is often desirable to compare the results of companies from different countries that report using different accounting standards. We provide at the end of each chapter a section called *A Look at U.S. GAAP*, to provide a comparison with IFRS.

Global Insight

The Korean Discount

Toru-Hanai/Pool/
Getty Images

If you think that accounting standards don't matter, consider these events in South Korea. For many years, international investors complained that the financial reports of South Korean companies were inadequate and inaccurate. Accounting practices there often resulted in huge differences between stated revenues and actual revenues. Because investors did not have faith in the accuracy of the numbers, they were unwilling to pay as much for the shares of these companies relative to shares of comparable companies in different countries. This difference in share price was often referred to as the "Korean discount."

In response, Korean regulators decided that companies would have to comply with international accounting standards. This change was motivated by a desire to "make the country's businesses more transparent" in order to build investor confidence and spur economic growth. Many other Asian countries, including China, India, Japan, and Hong Kong, have also decided either to adopt international standards or to create standards that are based on the international standards.

Source: Based on Evan Ramstad, "End to 'Korea Discount'?" *Wall Street Journal* (March 16, 2007).

What is meant by the phrase "make the country's businesses more transparent"? Why would increasing transparency spur economic growth?

Answer

Measurement Principles

IFRS uses one of two measurement bases, the historical cost basis or the current value basis. Selection of which basis to use is generally determined by considering the qualitative characteristics of useful information, including relevance and faithful representation (see Helpful Hint). **Relevance** means that financial information is capable of making a difference in a decision. **Faithful representation** means that the numbers and descriptions match what really existed or happened—they are factual.

HELPFUL HINT

***Relevance* and *faithful representation* are two primary qualities that make accounting information useful for decision-making.**

Historical Cost

The **historical cost basis** records and reports assets at their cost. This is true not only at the time the asset is purchased, but also over the time the asset is held. For example, if Great Wall Manufacturing purchases land for ¥300,000 (amounts in thousands), the company initially reports it in its accounting records at ¥300,000. But what does Great Wall do if, by the end of the next year, the current value of the land has increased to ¥400,000? Under the historical cost basis, it continues to report the land at ¥300,000.

Current Value

The **current value basis** records and reports assets and other accounts at current value. Depending on the nature of the item being reported, current value is determined based on the item's fair value (the price received to sell an asset or settle a liability), value in use (the present value of the future cash flows associated with the item), or current cost (the current replacement cost of the item).

Current value information may be more useful than historical cost for certain types of assets and liabilities. For example, certain investment securities are reported at current value because market value information is usually readily available for these types of assets.

- In determining which measurement basis to use, companies weigh the factual nature of historical cost figures versus the relevance of current value.
- In general, even though IFRS allows companies to revalue property, plant, and equipment and other long-lived assets to current value, most companies choose to use cost.

Only in situations where assets are actively traded, such as investment securities, do companies apply the current value extensively.

Assumptions

Assumptions provide a foundation for the accounting process. Two main assumptions are the **monetary unit assumption** and the **economic entity assumption**.

Monetary Unit Assumption

The **monetary unit assumption** requires that companies include in the accounting records only transaction data that can be expressed in money terms. This assumption enables accounting to quantify (measure) economic events. The monetary unit assumption is vital to using the historical cost basis.

This assumption prevents the inclusion of some relevant information in the accounting records. For example, the health of a company's owner, the quality of service, and the morale of employees are not included. The reason: Companies cannot quantify this information in money terms. Though this information is important, companies record only events that can be measured in money. Throughout this text, we use a variety of currencies in our examples and end-of-chapter materials, such as the following.

Australia, dollar	$	Russia, ruble	P
Brazil, real	R$	South Africa, rand	R
China, yuan renminbi	¥	South Korea, won	₩
Europe, euro	€	Switzerland, Swiss franc	CHF
Hong Kong, dollar	HK$	Taiwan, new dollar	NT$
India, rupee	₹	Turkey, lira	₺
Indonesia, rupia	Rp	United Kingdom, pound	£
Japan, yen	¥	United States, dollar	$

Economic Entity Assumption

An economic entity can be any organization or unit in society. It may be a company (such as **Maruti Suzuki** (IND)), a governmental unit (the Indonesian province of Papua), a municipality (Beijing), or a temple (the Temple of the Six Banyan Trees). The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities. To illustrate, Barb Su, owner of Barb's Bike Shop, must keep her personal living costs separate from the expenses of the business. Similarly, **Maxway Cycles Co.** (TWN) and **Asia Bicycle Trading Company** (TWN) are segregated into separate economic entities for accounting purposes (see Ethics Note).

> **ETHICS NOTE**
>
> **The importance of the economic entity assumption is illustrated by scandals involving Adelphia (USA). In this case, senior company employees entered into transactions that blurred the line between the employees' financial interests and those of the company. For example, Adelphia guaranteed over $2 billion of loans to the founding family.**

***Ethics Notes** help sensitize you to some of the ethical issues in accounting.*

Proprietorship

A business owned by one person is generally a **proprietorship**. The owner is often the manager/operator of the business. Small service-type businesses (plumbing companies, beauty salons, and auto repair shops), farms, and small retail stores (antique shops, clothing stores, and used-book stores) are often proprietorships.

- Usually, only a relatively small amount of money (capital) is necessary to start in business as a proprietorship.

- The owner (proprietor) receives any profits, suffers any losses, and is personally liable for all debts of the business.

There is no legal distinction between the business as an economic unit and the owner, but the accounting records of the business activities are kept separate from the personal records and activities of the owner.

Partnership

A business owned by two or more persons associated as partners is a **partnership**. In most respects a partnership is like a proprietorship except that more than one owner is involved.

- Typically, a partnership agreement (written or oral) sets forth such terms as initial investment, duties of each partner, division of net income (or net loss), and settlement to be made upon death or withdrawal of a partner.
- Each partner generally has unlimited personal liability for the debts of the partnership.
- Like a proprietorship, for accounting purposes the partnership transactions must be kept separate from the personal activities of the partners.

Partnerships are often used to organize retail and service-type businesses, including professional practices (lawyers, doctors, architects, and accountants).

Corporation

A business organized as a separate legal entity under jurisdiction corporation law and having ownership divided into transferable shares is a **corporation**.

- The holders of the shares (shareholders) enjoy limited liability; that is, they are not personally liable for the debts of the corporate entity.
- Shareholders may transfer all or part of their ownership shares to other investors at any time (i.e., sell their shares). The ease with which ownership can change adds to the attractiveness of investing in a corporation.
- Because ownership can be transferred without dissolving the corporation, the corporation enjoys an unlimited life.

Although the combined number of proprietorships and partnerships in the world significantly exceeds the number of corporations, the revenue produced by corporations is much greater. Most of the largest companies in the world—for example, **ING** (NLD), **Royal Dutch Shell** (GBR and NLD), **Apple Inc.** (USA), **Fortis** (BEL), and **Toyota** (JPN)—are corporations.

Accounting Across the Organization

Spinning the Career Wheel

blublaf/E+/Getty Images

One question that students frequently ask is, "How will the study of accounting help me?" A working knowledge of accounting is desirable for virtually *every field* of endeavor. Some examples of how accounting is used in other careers include the following.

General management: Imagine running **Volkswagen** (DEU), **Saudi Telecom** (SAU), a **Subway** (USA) franchise, or a **Fuji** (JPN) bike shop. All general managers need to understand where the company's cash comes from and where it goes in order to make wise business decisions.

Marketing: Marketing specialists at a company like **Hyundai Motor** (KOR) develop strategies to help the sales force be successful. But making a sale is meaningless unless it is profitable. Marketing people must be sensitive to costs and benefits, which accounting helps them quantify and understand.

Finance: Do you want to be a banker for **Shanghai Commercial and Savings Bank** (TWN) or a financial analyst for **ICBC** (CHN)? These fields rely heavily on accounting. In all of them, you will regularly examine and analyze financial statements. In fact, it is difficult to get a good finance job without two or three courses in accounting.

Real estate: Are you interested in being a real estate broker for **Hong Kong Property Services** (HKG)? Because a third party—the bank—is almost always involved in financing a real estate transaction, brokers must understand the numbers involved: Can the buyer afford to make the payments to the bank? Does the cash flow from an industrial property justify the purchase price? What are the tax benefits of the purchase?

How might accounting help you?

Answer

DO IT! 2

Building Blocks of Accounting

Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. Ethics are the standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.
2. The primary accounting standard-setting body headquartered in London is the International Accounting Standards Board (IASB).
3. An asset recorded using the historical cost basis results in recording assets at their cost. In later periods, however, the current value of the asset must be used if current value is higher than its cost.
4. Relevance means that financial information matches what really happened; the information is factual.
5. A business owner's personal expenses must be separated from expenses of the business to comply with accounting's economic entity assumption.

ACTION PLAN

- **Review the discussion of ethics and financial reporting standards.**
- **Develop an understanding of the key terms used.**

Solution

Related exercise material: **DO IT! 1.2**, **E1.3**, **and** **E1.4**.

1.3 The Accounting Equation

LEARNING OBJECTIVE 3

State the accounting equation, and define its components.

The two basic elements of a business are what it owns and what it owes.

- **Assets** are the resources a business owns. For example, **adidas** (DEU) has total assets of approximately €15,176 billion. Liabilities and equity are the rights or claims against these resources. Thus, adidas has €15,176 billion of claims against its €15,176 billion of assets.
- Claims of those to whom the company owes money (creditors) are called **liabilities**.
- Claims of owners are called **equity**. adidas has liabilities of €8,721 billion and equity of €6,455 billion.

We can express the relationship of assets, liabilities, and equity as an equation, as shown in **Illustration 1.6**.

ILLUSTRATION 1.6 **The basic accounting equation**

Assets	=	**Liabilities**	+	**Equity**

This relationship is the **basic accounting equation**.

- Assets must equal the sum of liabilities and equity.
- Liabilities appear before equity in the basic accounting equation because they are paid first if a business is liquidated.

The accounting equation applies to all **economic entities** regardless of size, nature of business, or form of business organization. It applies to a small proprietorship such as a corner grocery store as well as to a giant corporation such as adidas. The equation provides the **underlying framework** for recording and summarizing economic events.

Let's look in more detail at the categories in the basic accounting equation.

Assets

As noted previously, assets are resources a business owns. The business uses its assets in carrying out such activities as production and sales.

- The common characteristic possessed by all assets is **the capacity to provide future services or benefits**.
- In a business, that service potential or future economic benefit eventually results in cash inflows (receipts).

For example, consider Taipei Pizza, a local restaurant. It owns a delivery truck that provides economic benefits from delivering pizzas. Other assets of Taipei Pizza are tables, chairs, sound system, cash register, oven, tableware, and, of course, cash.

Liabilities

Liabilities are claims against assets—that is, existing debts and obligations. Businesses of all sizes usually borrow money and purchase merchandise on credit. These economic activities result in payables of various sorts:

- Taipei Pizza, for instance, purchases cheese, sausage, flour, and beverages on credit from suppliers. These obligations are called **accounts payable**.
- Taipei Pizza also has a **note payable** to First Bank for the money borrowed to purchase the delivery truck.
- Taipei Pizza may also have **salaries and wages payable** to employees and **sales and real estate taxes payable** to the local government.

All of these persons or entities to whom Taipei Pizza owes money are its **creditors**.

Creditors may legally force the liquidation of a business that does not pay its debts. In that case, the law requires that creditor claims be paid **before** ownership claims.

Equity

The ownership claim on a company's total assets is equity. It is equal to total assets minus total liabilities. Here is why.

- The assets of a business are claimed by either creditors or shareholders. To find out what belongs to shareholders, we subtract creditors' claims (the liabilities) from the assets.
- The remainder is the shareholders' claim on the assets—equity. It is often referred to as **residual equity**—that is, the equity "left over" after creditors' claims are satisfied.

Equity generally consists of (1) share capital—ordinary and (2) retained earnings.

Share Capital—Ordinary

A company may obtain funds by selling ordinary shares to investors. Share capital—ordinary is the term used to describe the amounts paid in by shareholders for the ordinary shares they purchase.

Retained Earnings

Retained earnings is determined by three items: revenues, expenses, and dividends.

Revenues

Revenues are the gross increases in equity resulting from business activities entered into for the purpose of earning income (see Helpful Hint).[3] Generally, revenues result from selling merchandise, performing services, renting property, and lending money.

> **HELPFUL HINT**
>
> **The effect of revenues is positive—an increase in equity coupled with an increase in assets or a decrease in liabilities.**

Revenues usually result in an increase in an asset. They may arise from different sources and are called various names depending on the nature of the business. Taipai Pizza, for instance, has two categories of sales revenues —pizza sales and beverage sales. Other titles for and sources of revenue common to many businesses are sales, fees, services, commissions, interest, dividends, royalties, and rent.

Expenses

Expenses are the cost of assets consumed or services used in the process of earning revenue. **They are decreases in equity that result from operating the business** (see Helpful Hint). Like revenues, expenses take many forms and are called various names depending on the type of asset consumed or service used.

> **HELPFUL HINT**
>
> **The effect of expenses is negative—a decrease in equity coupled with a decrease in assets or an increase in liabilities.**

For example, Taipai Pizza recognizes the following types of expenses: cost of ingredients (flour, cheese, tomato paste, meat, mushrooms, etc.), cost of beverages, wages expense, utilities expense (electric, gas, and water expense), telephone expense, delivery expense (gasoline, repairs, licenses, etc.), supplies expense (napkins, detergents, aprons, etc.), rent expense, interest expense, and property tax expense.

Dividends

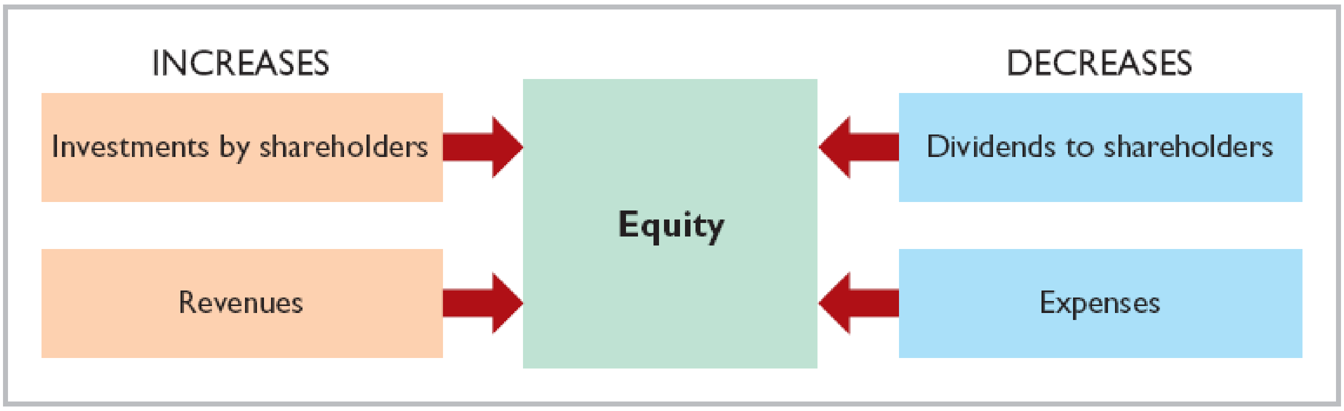
Net income represents an increase in net assets which is then available to distribute to shareholders. The distribution of cash or other assets to shareholders is called a **dividend**.

- Dividends reduce retained earnings.
- However, dividends are **not expenses**.

A corporation first determines its revenues and expenses and then computes net income or net loss. If it has net income, and decides it has no better use for that income, a corporation may decide to distribute a dividend to its owners (the shareholders).

In summary, the principal sources (increases) of equity are investments by shareholders and revenues from business operations. In contrast, reductions (decreases) in equity result from expenses and dividends. These relationships are shown in **Illustration 1.7**.

ILLUSTRATION 1.7 Increases and decreases in equity



DO IT! 3

Equity Effects

Classify the following items as issuance of shares (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

a. Rent Expense.

b. Service Revenue.

c. Dividends.

d. Salaries and Wages Expense.

ACTION PLAN

- **Understand the sources of revenue.**
- **Understand what causes expenses.**
- **Review the rules for changes in equity: Investments and revenues increase equity. Expenses and dividends decrease equity.**
- **Recognize that dividends are distributions of cash or other assets to shareholders.**

Solution

Related exercise material: BE1.1, BE1.2, BE1.3, BE1.4, BE1.5, BE1.6, DO IT! 1.3, **and** E1.5.

1.4 Analyzing Business Transactions

LEARNING OBJECTIVE 4

Analyze the effects of business transactions on the accounting equation.

This accounting cycle graphic illustrates the steps companies follow each period to record transactions and eventually prepare financial statements.

The system of collecting and processing transaction data and communicating financial information to decision-makers is known as the **accounting information system**. Factors that shape an accounting information system include the nature of the company's business, the types of transactions, the size of the company, the volume of data, and the information demands of management and others.

Most businesses use computerized accounting systems—sometimes referred to as electronic data processing (EDP) systems. These systems handle all the steps involved in the recording process, from initial data entry to preparation of the financial statements. Many companies upgraded their accounting information systems to prevent cybersecurity attacks. In addition, companies are utilizing new technologies.

- Cloud-based storage permits employees to access records from different locations.
- Data automation and analytics tools help companies interpret large volumes of data to support enhanced decision-making and automating routine processes.

In order to remain competitive, companies continually improve their accounting systems to provide accurate and timely data for decision-making. For example, in a recent annual report, **Tootsie Roll** (USA) stated, "We also invested in additional processing and data storage hardware during the year. We view information technology as a key strategic tool, and are committed to deploying leading edge technology in this area."

Accounting information systems rely on a process referred to as **the accounting cycle**. As you can see from the graphic, the accounting cycle begins with the analysis of business transactions and ends with the preparation of a post-closing trial balance. We explain each of the steps, starting in this chapter and continuing in Chapters 2–4.

In this text, in order to emphasize the underlying concepts and principles, we focus on a manual accounting system. The accounting concepts and principles do not change whether a system is computerized or manual.

Accounting Transactions

Transactions (**business transactions**) are a business's economic events recorded by accountants. Transactions may be external or internal.

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

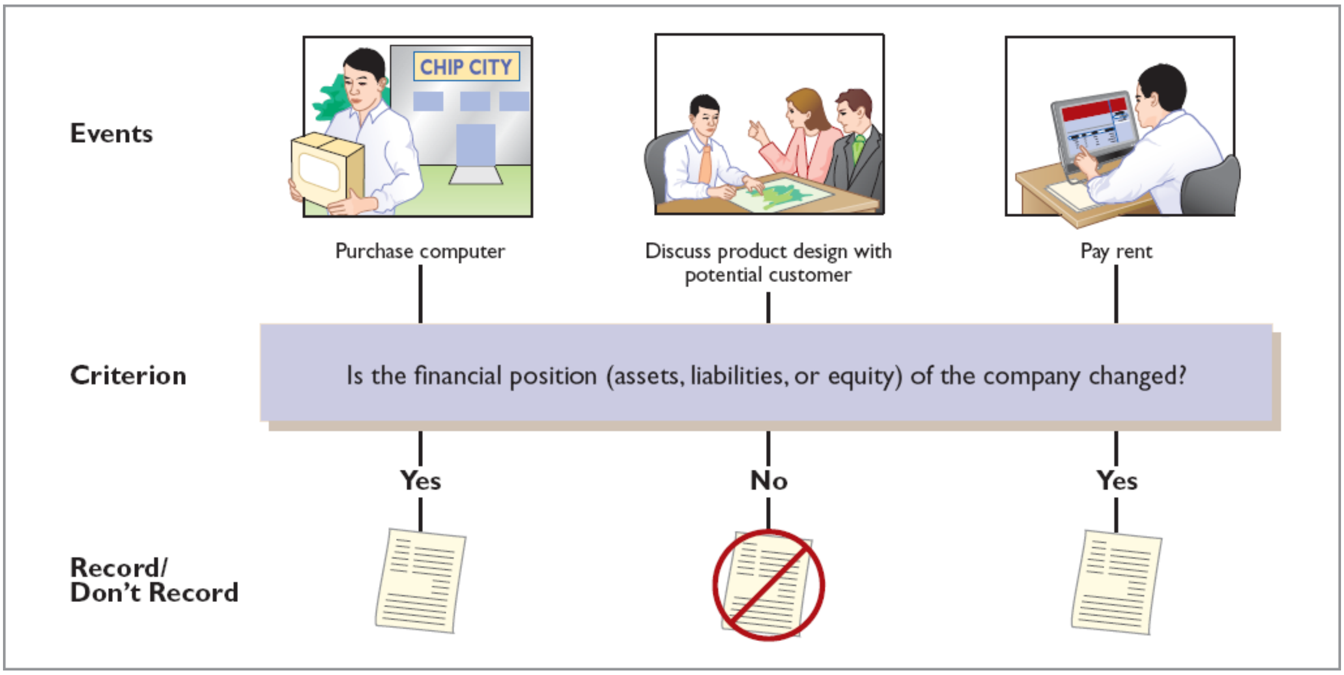
Companies carry on many activities that do not represent business transactions. Examples are hiring employees, responding to e-mails, talking with customers, and placing merchandise orders. Some of these activities may lead to business transactions. Employees will earn wages, and suppliers will deliver ordered merchandise.

A company must analyze each event to find out if it affects the components of the accounting equation. If it does, the company will record the transaction. Illustration 1.8 demonstrates the transaction identification process.

Each transaction must have a dual effect on the accounting equation. For example, if an asset is increased, there must be a corresponding:

- Decrease in another asset, *or*
- Increase in a specific liability, *or*
- Increase in equity.

ILLUSTRATION 1.8 Transaction identification process



Two or more items could be affected. For example, as one asset is increased €10,000, another asset could decrease €6,000 and a liability could increase €4,000. Any change in a liability or ownership claim is subject to similar analysis.

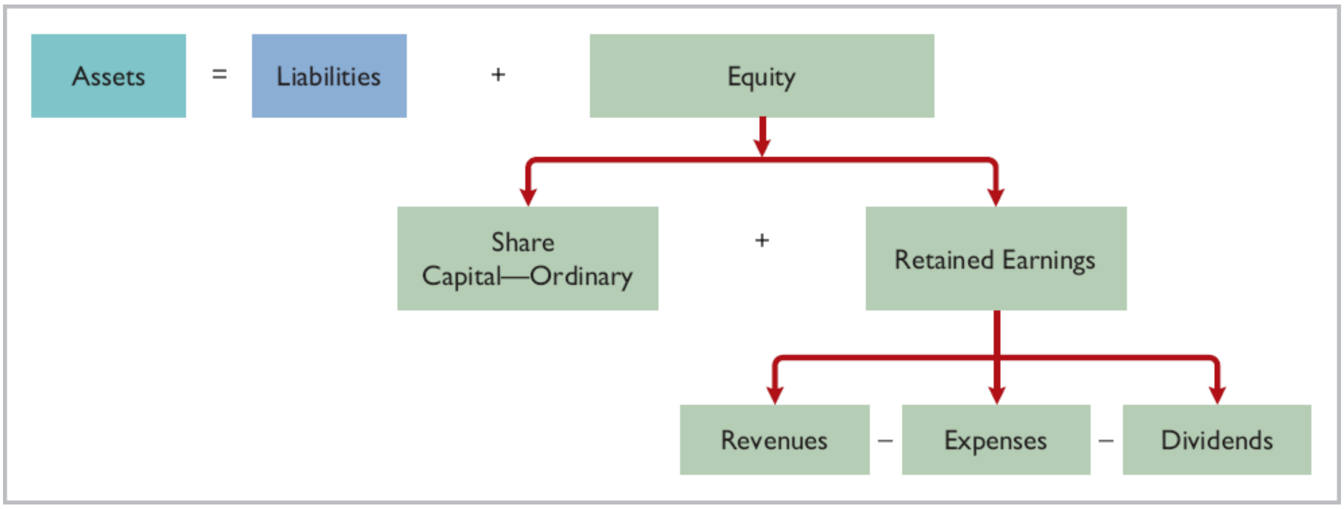
Transaction Analysis

To demonstrate how to analyze transactions in terms of the accounting equation, we will review the business activities of Softbyte SA. As part of this analysis, we will expand the basic accounting equation. This will allow us to better illustrate the impact of transactions on equity. Recall that equity is comprised of two parts: share capital—ordinary and retained earnings.

- Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash.
- Retained earnings is affected when the company earns revenue, incurs expenses, or pays dividends.

Illustration 1.9 shows the expanded accounting equation.

ILLUSTRATION 1.9 Expanded accounting equation



If you are tempted to skip ahead after you've read a few of the following transaction analyses, don't do it. Each has something unique to teach, something you'll need later (see Helpful Hint). (We assure you that we've kept them to the minimum needed!)

> **HELPFUL HINT**
>
> **You will want to study these transactions until you are sure you understand them. They are not difficult, but understanding them is important to your success in this course. The ability to analyze transactions in terms of the basic accounting equation is essential in accounting.**

Transaction (1). Investment by Shareholders

Ray and Barbara Neal decide to start a smartphone app development company that they incorporate as Softbyte SA. On September 1, 2025, they invest €15,000 cash in the business in exchange for €15,000 of ordinary shares. The ordinary shares indicates the ownership interest that the Neals have in Softbyte SA. This transaction results in an equal increase in both assets and equity.[4]

Basic Analysis	The asset Cash increases €15,000, and equity identified as Share Capital—Ordinary increases €15,000.

Equation Analysis

	Assets	=	Liabilities	+	Equity	
	Cash	=			Share Capital	
(1)	+€15,000	=			+€15,000	Issued Shares

Observe that the equality of the basic equation has been maintained. Note also that the source of the increase in equity (in this case, issued shares) is indicated. Why does this matter?

- Because investments by shareholders do not represent revenues, and they are excluded in determining net income.
- Therefore, it is necessary to make clear that the increase is an investment rather than revenue from operations.

Additional investments (i.e., investments made by shareholders after the corporation has been initially formed) have the same effect on equity as the initial investment.

Transaction (2). Purchase of Equipment for Cash

Softbyte SA purchases computer equipment for €7,000 cash. This transaction results in an equal increase and decrease in total assets, though the composition of assets changes.

Basic Analysis	The asset Cash decreases €7,000, and the asset Equipment increases €7,000.

Equation Analysis

	Assets			=	Liabilities	+	Equity
	Cash	+	Equipment	=			Share Capital
	€15,000						€15,000
(2)	−7,000		+€7,000				
	€ 8,000	+	€7,000	=			€15,000
	€15,000						

Observe that total assets are still €15,000. Share Capital—Ordinary also remains at €15,000, the amount of the original investment.

Transaction (3). Purchase of Supplies on Credit

Softbyte SA purchases headsets (and other computer accessories expected to last several months) for €1,600 from Mobile Solutions. Mobile Solutions agrees to allow Softbyte to pay this bill in October.

- This transaction is a purchase on account (a credit purchase).
- Assets increase because of the expected future benefits of using the headsets and computer accessories, and liabilities increase by the amount due Mobile Solutions.

Basic Analysis	The asset Supplies increases €1,600, and the liability Accounts Payable increases €1,600.

Equation Analysis

	Assets					=	Liabilities	+	Equity
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital
	€8,000				€7,000				€15,000
(3)			+€1,600				+€1,600		
	€8,000	+	€1,600	+	€7,000	=	€1,600	+	€15,000
	€16,600						€16,600		

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

Transaction (4). Services Performed for Cash

Softbyte SA receives €1,200 cash from customers for app development services it has performed. This transaction represents Softbyte's principal revenue-producing activity. Recall that **revenue increases equity**.

Basic Analysis	The asset Cash increases €1,200, and equity increases €1,200 due to Service Revenue.

Equation Analysis

	Assets					=	Liabilities	+	Equity							
											Retained Earnings					
	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	Share Capital	+	Rev.	−	Exp.	−	Div.	
	€8,000		€1,600		€7,000		€1,600		€15,000							
(4)	+1,200										+€1,200					Service Revenue
	€9,200	+	€1,600	+	€7,000	=	€1,600	+	€15,000	+	€1,200					
	€17,800						€17,800									

The two sides of the equation balance at €17,800. Service Revenue is included in determining Softbyte's net income.

- Note that we do not have room to give details for each individual revenue and expense account in this illustration. Thus, revenues (and expenses when we get to them) are summarized under one column heading for Revenues and one for Expenses.

- However, it is important to keep track of the category (account) titles affected (e.g., Service Revenue) as they will be needed when we prepare financial statements later in the chapter.

Transaction (5). Purchase of Advertising on Credit

Softbyte SA receives a bill for €250 from *Programming News* for advertising on its website but postpones payment until a later date. This transaction results in an increase in liabilities and a decrease in equity.

Basic Analysis	The liability Accounts Payable increases €250, and equity decreases €250 due to Advertising Expense.

Equation Analysis

	Assets					=	Liabilities	+	Equity							
							Accounts		Share		Retained Earnings					
	Cash	+	Supplies	+	Equipment	=	Payable	+	Capital	+	Rev.	−	Exp.	−	Div.	
	€9,200		€1,600		€7,000		€1,600		€15,000		€1,200					
(5)							+250						−€250			Advertising Expense
	€9,200	+	€1,600	+	€7,000	=	€1,850	+	€15,000	+	€1,200	−	€250			
	€17,800						€17,800									

The two sides of the equation still balance at €17,800. Retained Earnings decreases when Softbyte incurs the expense.

- Expenses do not have to be paid in cash at the time they are incurred.
- When Softbyte pays at a later date, the liability Accounts Payable will decrease and the asset Cash will decrease [see Transaction (8)].

The cost of advertising is an expense (rather than an asset) because Softbyte has used the benefits. Advertising Expense is included in determining net income.

Transaction (6). Services Performed for Cash and Credit

Softbyte SA performs €3,500 of app development services for customers. The company receives cash of €1,500 from customers, and it bills the balance of €2,000 on account. This transaction results in an equal increase in assets and equity.

Basic Analysis	Three specific items are affected: The asset Cash increases €1,500, the asset Accounts Receivable increases €2,000, and equity increases €3,500 due to Service Revenue.

Equation Analysis

	Assets							=	Liabilities	+	Equity							
			Accounts						Accounts		Share		Retained Earnings					
	Cash	+	Receivable	+	Supplies	+	Equipment	=	Payable	+	Capital	+	Rev.	−	Exp.	−	Div.	
	€ 9,200				€1,600		€7,000		€1,850		€15,000		€1,200		€250			
(6)	+1,500		+€2,000										+3,500					Service Revenue
	€10,700	+	€2,000	+	€1,600	+	€7,000	=	€1,850	+	€15,000	+	€4,700	−	€250			
	€21,300								€21,300									

Softbyte recognizes €3,500 in revenue when it performs the services. In exchange for these services, it received €1,500 in Cash and Accounts Receivable of €2,000. This Accounts Receivable represents customers' promise to pay €2,000 to Softbyte in the future. When it later receives collections on account, Softbyte will increase Cash and will decrease Accounts Receivable [see Transaction (9)].

Transaction (7). Payment of Expenses

Softbyte SA pays the following expenses in cash for September: office rent €600, salaries and wages of employees €900, and utilities €200. These payments result in an equal decrease in assets and equity.

Basic Analysis	The asset Cash decreases €1,700, and equity decreases €1,700 due to the following specific expenses: Rent Expense, Salaries and Wages Expense, and Utilities Expense.

Equation Analysis

	Assets				=	Liabilities	+	Equity				
		Accounts				Accounts		Share	Retained Earnings			
	Cash +	Receivable +	Supplies +	Equipment	=	Payable	+	Capital +	Rev. −	Exp. −	Div.	
	€10,700	€2,000	€1,600	€7,000		€1,850		€15,000	€4,700	€ 250		
(7)	−1,700									−600		Rent Exp.
										−900		Sal./Wages Exp.
										−200		Utilities Exp.
	€ 9,000 +	€2,000 +	€1,600 +	€7,000	=	€1,850	+	€15,000 +	€4,700 −	€1,950		
	€19,600					€19,600						

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

Transaction (8). Payment of Accounts Payable

Softbyte SA pays its €250 *Programming News* bill in cash. The company previously [in Transaction (5)] recorded the bill as an increase in Accounts Payable and a decrease in equity.

Basic Analysis	This cash payment "on account" decreases the asset Cash by €250 and also decreases the liability Accounts Payable by €250.

Equation Analysis

	Assets				=	Liabilities	+	Equity			
		Accounts				Accounts		Share	Retained Earnings		
	Cash +	Receivable +	Supplies +	Equipment	=	Payable	+	Capital +	Rev. −	Exp. −	Div.
	€9,000	€2,000	€1,600	€7,000		€1,850		€15,000	€4,700	€1,950	
(8)	−250					−250					
	€8,750 +	€2,000 +	€1,600 +	€7,000	=	€1,600	+	€15,000 +	€4,700 −	€1,950	
	€19,350					€19,350					

Observe that the payment of a liability related to an expense that has previously been recorded does not affect equity. Softbyte recorded the expense [in Transaction (5)] and should not record it again.

Transaction (9). Receipt of Cash on Account

Softbyte SA receives €600 in cash from customers who had been billed for services [in Transaction (6)]. Transaction (9) does not change total assets, but it changes the composition of those assets.

Basic Analysis	The asset Cash increases €600, and the asset Accounts Receivable decreases €600.

Equation Analysis

	Assets				=	Liabilities	+	Equity			
		Accounts				Accounts		Share	Retained Earnings		
	Cash +	Receivable +	Supplies +	Equipment	=	Payable	+	Capital +	Rev. −	Exp. −	Div.
	€8,750	€2,000	€1,600	€7,000		€1,600		€15,000	€4,700	€1,950	
(9)	+600	−600									
	€9,350 +	€1,400 +	€1,600 +	€7,000	=	€1,600	+	€15,000 +	€4,700 −	€1,950	
	€19,350					€19,350					

Note that the collection of an account receivable for services previously billed and recorded does not affect equity. Softbyte already recorded this revenue [in Transaction (6)] and should not record it again.

Transaction (10). Dividends

The company pays a dividend of €1,300 in cash to Ray and Barbara Neal, the shareholders of Softbyte SA. This transaction results in an equal decrease in assets and equity.

Basic Analysis	The asset Cash decreases €1,300, and equity decreases €1,300 due to dividends.

Equation Analysis

	Assets				= Liabilities +	Equity				
							Retained Earnings			
	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Rev. −	Exp. −	Div.	
	€9,350	€1,400	€1,600	€7,000	€1,600	€15,000	€4,700	€1,950		
(10)	−1,300								−€1,300	Dividends
	€8,050 +	€1,400 +	€1,600 +	€7,000 =	€1,600 +	€15,000 +	€4,700 −	€1,950 −	€1,300	
	€18,050				€18,050					

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

Summary of Transactions

Illustration 1.10 summarizes the September transactions of Softbyte SA to show their cumulative effect on the basic accounting equation. It also indicates the transaction number and the specific effects of each transaction. Finally, Illustration 1.10 demonstrates a number of significant facts:

1. Each transaction must be analyzed in terms of its effect on:
   a. The three components of the basic accounting equation.
   b. Specific types (kinds) of items within each component.
2. The two sides of the equation must always be equal.
3. The Share Capital—Ordinary and Retained Earnings columns indicate the causes of each change in the shareholders' claim on assets.

ILLUSTRATION 1.10 Tabular summary of Softbyte SA transactions

	Assets				= Liabilities +	Equity				
							Retained Earnings			
Transaction	Cash +	Accounts Receivable +	Supplies +	Equipment =	Accounts Payable +	Share Capital +	Rev. −	Exp. −	Div.	
(1)	+€15,000					+ €15,000				Issued Shares
(2)	−7,000			+€7,000						
(3)			+€1,600		+€1,600					
(4)	+1,200						+€1,200			Service Revenue
(5)					+250			−€250		Adver. Expense
(6)	+1,500	+€2,000					+3,500			Service Revenue
(7)	−1,700							−600		Rent Expense
								−900		Sal./Wages Exp.
								−200		Utilities Expense
(8)	−250				−250					
(9)	+600	−600								
(10)	−1,300								−€1,300	Dividends
	€ 8,050 +	€1,400 +	€1,600 +	€7,000 =	€1,600 +	€15,000 +	€4,700 −	€1,950 −	€1,300	
	€18,050				€18,050					

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

DO IT! 4

Tabular Analysis

Transactions made by Virmari & Co., a public accounting firm in France, for the month of August are shown below. Prepare a tabular analysis which shows the effects of these transactions on the expanded accounting equation, similar to that shown in Illustration 1.10.

1. The company issued ordinary shares for €25,000 cash.
2. The company purchased €7,000 of office equipment on credit.
3. The company received €8,000 cash in exchange for services performed.
4. The company paid €850 for this month's rent.
5. The company paid a dividend of €1,000 in cash to shareholders.

ACTION PLAN

- **Analyze the effects of each transaction on the accounting equation.**
- **Use appropriate category names (not descriptions).**
- **Keep the accounting equation in balance.**

Solution

Related exercise material: **BE1.7**, **BE1.8**, **BE1.9**, **DO IT! 1.4**, **E1.6**, **E1.7**, **and** **E1.8**.

1.5 Financial Statements

LEARNING OBJECTIVE 5

Describe the five financial statements and how they are prepared.

Companies prepare five financial statements from the summarized accounting data (see **Helpful Hint**):

1. An **income statement** presents the revenues and expenses and resulting net income or net loss for a specific period of time.
2. A **retained earnings statement** summarizes the changes in retained earnings for a specific period of time.[5]
3. A **statement of financial position** (sometimes referred to as a *balance sheet*) reports the assets, liabilities, and equity of a company at a specific date.
4. A **statement of cash flows** summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.
5. A **comprehensive income statement** presents other comprehensive income items that are not included in the determination of net income. Note that IFRS contains two concepts of income: net income and comprehensive income. In later chapters, we will provide more insight into the differences between these two income concepts.

HELPFUL HINT

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

These statements provide relevant financial data for internal and external users. **Illustration 1.11** shows the first four financial statements from the above list of Softbyte SA (see **Helpful Hints**). (Illustration 1.11 assumes Softbyte has no other comprehensive income items.) A comprehensive income statement is presented in Illustration 1.13 for Softbyte.

Note that the statements shown in Illustration 1.11 are interrelated:

1. Net income of €2,750 on the **income statement** is added to the beginning balance of retained earnings in the **retained earnings statement**.
2. Retained earnings of €1,450 at the end of the reporting period shown in the **retained earnings statement** is reported on the **statement of financial position**.
3. Cash of €8,050 on the **statement of financial position** is reported on the **statement of cash flows**.

Also, explanatory notes and supporting schedules are an integral part of every set of financial statements. We illustrate these notes and schedules in later chapters of this text.

Be sure to carefully examine the format and content of each statement in Illustration 1.11. We describe the essential features of each in the following sections.

HELPFUL HINT

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

HELPFUL HINT

The arrows in this illustration show the interrelationships of the four financial statements.

1. **Net income is computed first and is needed to determine the ending balance in retained earnings.**
2. **The ending balance in retained earnings is needed in preparing the statement of financial position.**
3. **The cash shown on the statement of financial position is needed in preparing the statement of cash flows.**

HELPFUL HINT

Note that final sums are double-underlined, and negative amounts (in the statement of cash flows) are presented in parentheses.

ILLUSTRATION 1.11 Financial statements and their interrelationships

Softbyte SA
Income Statement
For the Month Ended September 30, 2025

Revenues		
Service revenue		€4,700
Expenses		
Salaries and wages expense	€900	
Rent expense	600	
Advertising expense	250	
Utilities expense	200	
Total expenses		1,950
Net income		**€2,750**

Softbyte SA
Retained Earnings Statement
For the Month Ended September 30, 2025

Retained earnings, September 1	€ 0
Add: Net income	**2,750**
	2,750
Less: Dividends	1,300
Retained earnings, September 30	**€1,450**

Softbyte SA
Statement of Financial Position
September 30, 2025

Assets

Equipment		€ 7,000
Supplies		1,600
Accounts receivable		1,400
Cash		**8,050**
Total assets		€18,050

Equity and Liabilities

Equity		
Share capital—ordinary	€15,000	
Retained earnings	**1,450**	€16,450
Liabilities		
Accounts payable		1,600
Total equity and liabilities		€18,050

Softbyte SA
Statement of Cash Flows
For the Month Ended September 30, 2025

Cash flows from operating activities		
Cash receipts from revenues		€ 3,300
Cash payments for expenses		(1,950)
Net cash provided by operating activities		1,350
Cash flows from investing activities		
Purchase of equipment		(7,000)
Cash flows from financing activities		
Sale of ordinary shares	€15,000	
Payment of cash dividends	(1,300)	13,700

Payment of cash dividends	(1,300)	15,700
Net increase in cash		8,050
Cash at the beginning of the period		0
Cash at the end of the period		**€ 8,050**

Income Statement

The income statement reports the success or profitability of the company's operations over a specific period of time. For example, Softbyte SA's income statement is dated "For the Month Ended September 30, 2025." It is prepared from the data appearing in the revenue and expense columns of Illustration 1.10. The heading of the statement identifies the company, the type of statement, and the time period covered by the statement.

- The income statement lists revenues first, followed by expenses.
- Then, the statement shows net income (or net loss).
- When revenues exceed expenses, **net income** results. When expenses exceed revenues, a **net loss** results.

Although practice varies, we have chosen to list expenses in order of magnitude in our illustrations. (We will consider alternative formats for the income statement in later chapters.)

Note that the income statement does not include investment and dividend transactions between the shareholders and the business in measuring net income. For example, as explained earlier, the cash dividend from Softbyte SA was not regarded as a business expense. This type of transaction is considered a reduction of retained earnings, which causes a decrease in equity.

Retained Earnings Statement

Softbyte SA's retained earnings statement reports the changes in retained earnings for a specific period of time. The time period is the same as that covered by the income statement ("For the Month Ended September 30, 2025"). Data for the preparation of the retained earnings statement come from the retained earnings columns of the tabular summary (Illustration 1.10) and from the income statement (Illustration 1.11).

- The first line of the statement shows the beginning retained earnings amount, followed by net income and dividends.
- The retained earnings ending balance is the final amount on the statement.
- The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period. If there is a net loss, it is deducted with dividends in the retained earnings statement.

Statement of Financial Position

Softbyte SA's statement of financial position reports the assets, liabilities, and equity at a specific date (September 30, 2025). The company prepares the statement of financial position from the column headings and the month-end data shown in the last line of the tabular summary (Illustration 1.10).

- Observe that the statement of financial position lists assets at the top, followed by equity and then liabilities.
- Total assets must equal total equity and liabilities.

Softbyte SA reports only one liability, Accounts Payable, on its statement of financial position. In most cases, there will be more than one liability. When two or more liabilities are involved, a customary way of listing is as shown in **Illustration 1.12**.

ILLUSTRATION 1.12 Presentation of liabilities

Liabilities	
Notes payable	€10,000
Accounts payable	63,000
Salaries and wages payable	18,000
Total liabilities	**€91,000**

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

Accounting Across the Organization

Vodafone

A Wise End

Chris Ison/AP Photos

Not every company uses December 31 as the accounting year-end. Some companies whose year-ends differ from December 31 are **Vodafone Group** (GBR), March 31; **Walt Disney Company** (USA), the Saturday closest to September 30; and **Diageo** (GBR), June 30. Why do companies choose the particular year-ends that they do?

Many companies opt to end the accounting year when inventory or operations are at a low. Compiling accounting information requires much time and effort by managers, so companies would rather do it when they aren't as busy operating the business. Also, inventory is easier and less costly to count when it is low.

What year-end would you likely use if you owned a ski resort and ski rental business? What if you owned a college bookstore? Why choose those year-ends?

Answer

Statement of Cash Flows

The statement of cash flows provides information on the cash receipts and payments for a specific period of time. The statement of cash flows reports (1) the cash effects of a company's operations during a period, (2) its investing activities, (3) its financing activities, (4) the net increase or decrease in cash during the period, and (5) the cash amount at the end of the period (see Helpful Hint).

HELPFUL HINT

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

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

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

As shown in Softbyte SA's statement of cash flows in Illustration 1.11, cash increased €8,050 during the period. Net cash provided by operating activities increased cash €1,350. Cash flow from investing activities decreased cash €7,000. And cash flow from financing activities increased cash €13,700. At this time, you need not be concerned with how these amounts are determined. Chapter 13 will examine in detail how the statement is prepared.

Comprehensive Income Statement

In some cases, Softbyte SA must prepare a comprehensive income statement in addition to its income statement. Softbyte prepares this second statement if it has other comprehensive income items.

- Other comprehensive income items are not part of net income but are considered important enough to be reported separately.

- Softbyte adds other comprehensive income to net income to arrive at comprehensive income.

Illustration 1.13 shows a comprehensive income statement, assuming that Softbyte SA has other comprehensive income of €600.

ILLUSTRATION 1.13 Comprehensive income statement

Softbyte SA
Comprehensive Income Statement
For the Month Ended September 30, 2025

Net income	€2,750
Other comprehensive income	600
Comprehensive income	€3,350

In this two statement format, the comprehensive income statement is reported directly after the traditional income statement. Examples of this two statement format can be seen in the financial statements of **Nestlé** and **Delfi Limited** in Appendices B and C, respectively.

IFRS does allow an alternative statement format in which the information contained in the income statement and the comprehensive income statement are combined in a single statement, referred to as a **statement of comprehensive income**. An example of this approach can be seen in the financial statements of **TSMC** in Appendix A. *In this text, we use the two statement approach*. We provide a more detailed discussion about the components of other comprehensive income in later chapters.

Environmental, Social, and Governance Insight

Beyond Financial Statements

Marek Uliasz/
Getty Images

Should we expand our financial statements beyond the income statement, retained earnings statement, statement of financial position, and statement of cash flows? Some believe we should take into account ecological and social performance, in addition to financial results, in evaluating a company. The argument is that a company's responsibility lies with anyone who is influenced by its actions. In other words, a company should be interested in benefiting many different parties, instead of only maximizing shareholders' interests.

A socially responsible business does not exploit or endanger any group of individuals. It follows fair trade practices, provides safe environments for workers, and bears responsibility for environmental damage. Granted, measurement of these factors is difficult. How to report this information is also controversial. But, many interesting and useful efforts are underway.

Throughout this text, we provide additional insights into how companies are attempting to meet the challenge of measuring and reporting their contributions to society, as well as their financial results, to shareholders.

Why might a company's shareholders be interested in its environmental and social performance?

Answer

DO IT! 5

Financial Statement Items

Presented below is selected information related to Li Fashions at December 31, 2025. Li reports financial information monthly.

Equipment	HK$10,000	Utilities Expense	HK$ 4,000
Cash	8,000	Accounts Receivable	9,000
Service Revenue	36,000	Salaries and Wages Expense	7,000
Rent Expense	11,000	Notes Payable	16,500
Accounts Payable	2,000	Dividends	5,000

a. Determine the total assets of Li at December 31, 2025.

b. Determine the net income that Li reported for December 2025.

c. Determine the equity of Li at December 31, 2025.

ACTION PLAN

- **Remember the basic accounting equation: assets must equal liabilities plus equity.**
- **Review previous financial statements to determine how total assets, net income, and equity are computed.**

Solution

Related exercise material: **BE1.10**, **BE1.11**, **DO IT! 1.5**, **E1.9**, **E1.10**, **E1.11**, **E1.12**, **E1.13**, **E1.14**, **E1.15**, **E1.16**, **E1.17**, **and E1.18**.

Appendix 1A Career Opportunities in Accounting

LEARNING OBJECTIVE *6

Explain the career opportunities in accounting.

Why is accounting such a popular major and career choice?

- There are a lot of jobs. In many cities in recent years, the demand for accountants exceeded the supply. Not only are there a lot of jobs, but there are a wide array of opportunities. As one accounting organization observed, "accounting is one degree with 360 degrees of opportunity."
- It is obvious that accounting matters. Interest in accounting has increased, ironically, because of the attention caused by the turmoil over toxic (misstated) assets at many financial institutions. These widely publicized scandals revealed the important role that accounting plays in society. Most people want to make a difference, and an accounting career provides many opportunities to contribute to society.
- Recent internal control requirements dramatically increased demand for professionals with accounting training.

Accountants are in such demand that it is not uncommon for accounting students to have accepted a job offer a year before graduation. As the following discussion reveals, the job options of people with accounting degrees are virtually unlimited.

Public Accounting

Individuals in **public accounting** offer expert service to the general public, in much the same way that doctors serve patients and lawyers serve clients. A major portion of public accounting involves **auditing**. In auditing, an independent accountant such as a Chartered Accountant (CA) or a certified public accountant (CPA) examines company financial statements and provides an opinion as to how accurately the financial statements present the company's results and financial position in accordance with international financial reporting standards. Analysts, investors, and creditors rely heavily on these "audit opinions," which CAs and CPAs have the exclusive authority to issue.

Taxation is another major area of public accounting. The work that tax specialists perform includes tax advice and planning, preparing tax returns, and representing clients before governmental agencies.

A third area in public accounting is **management consulting**. It ranges from installing basic accounting software or highly complex enterprise resource planning systems, to performing support services for major marketing projects and merger and acquisition activities.

Many accountants are entrepreneurs. They form small- or medium-sized practices that frequently specialize in tax or consulting services.

Private Accounting

Instead of working in public accounting, you might choose to be an employee of a for-profit company such as **Sinopec** (CHN), **Google** (USA), or **Samsung** (KOR). In **private** (or **managerial**) **accounting**, you would be involved in activities such as cost accounting (finding the cost of producing specific products), budgeting, accounting information system design and support, and tax planning and preparation. You might also be a member of your company's internal audit team. In response to increased internal control requirements, the internal auditors' job of reviewing the company's operations to ensure compliance with company policies and to increase efficiency has taken on greater importance.

Alternatively, many accountants work for not-for-profit organizations such as the **International Red Cross** (CHE) or the **Bill and Melinda Gates Foundation** (USA), or for museums, libraries, or performing arts organizations.

Governmental Accounting

Another option is to pursue one of the many accounting opportunities in governmental agencies. For example, tax authorities, law enforcement agencies, and company regulators all employ accountants. There is also a very high demand for accounting educators at public colleges and universities and in local governments.

Forensic Accounting

Forensic accounting uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud. It is listed among the top 20 career paths of the future. The job of forensic accountants is to catch the perpetrators of theft and fraud occurring at companies. This includes tracing money-laundering and identity-theft activities as well as tax evasion. Insurance companies hire forensic accountants to detect frauds such as arson, and law offices employ forensic accountants to identify marital assets in divorces.

The Review and Practice section provides opportunities for students to review key concepts and terms as well as complete multiple-choice questions, brief exercises, exercises, and a comprehensive problem. Detailed solutions are also included.

Review and Practice

Learning Objectives Review

1 Identify the activities and users associated with accounting.

Accounting is an information system that identifies, records, and communicates the economic events of an organization to interested users. The major users and uses of accounting are as follows. (a) Management uses accounting information to plan, organize, and run the business. (b) Investors (owners) decide whether to buy, hold, or sell their financial interests on the basis of accounting data. (c) Creditors (suppliers and bankers) evaluate the risks of granting credit or lending money on the basis of accounting information. Other groups that use accounting information are taxing authorities, regulatory agencies, customers, and labor unions.

2 Explain the building blocks of accounting: ethics, principles, and assumptions.

Ethics are the standards of conduct by which actions are judged as right or wrong. Effective financial reporting depends on sound ethical behavior.

Accounting is based on standards such as International Financial Reporting Standards (IFRS). IFRS generally uses one of two measurement principles. The monetary unit assumption requires that companies include in the accounting records only transaction data that can be expressed in terms of money. The economic entity assumption requires that the activities of each economic entity be kept separate from the activities of its owner(s) and other economic entities.

3 State the accounting equation, and define its components.

The basic accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Assets are resources a business owns. Liabilities are creditorship claims on total assets. Equity is the ownership claim on total assets.

The expanded accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Share Capital—Ordinary} + \text{Revenues} - \text{Expenses} - \text{Dividends}$$

Share capital—ordinary is affected when the company issues new ordinary shares in exchange for cash. Revenues are the gross increase in equity resulting from business activities for the purpose of earning income. Expenses are the costs of assets consumed or services used in the process of earning revenue. Dividends are payments the company makes to its shareholders.

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

Each business transaction must have a dual effect on the accounting equation. For example, if an individual asset increases, there must be a corresponding (1) decrease in another asset, (2) increase in a specific liability, or (3) increase in equity.

5 Describe the five financial statements and how they are prepared.

An income statement presents the revenues and expenses, and resulting net income or net loss, for a specific period of time. A retained earnings statement summarizes the changes in retained earnings for a specific period of time. A statement of financial position reports the assets, liabilities, and equity at a specific date. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time. A comprehensive income statement adds or subtracts any items of other comprehensive income to net income to arrive at comprehensive income.

***6 Explain the career opportunities in accounting.**

Accounting offers many different jobs in fields such as public and private accounting, governmental, and forensic accounting. Accounting is a popular major because there are many different types of jobs, with unlimited potential for career advancement.

Glossary Review

Accounting
The information system that identifies, records, and communicates the economic events of an organization to interested users.

Accounting information system
The system of collecting and processing transaction data and communicating financial information to decision-makers.

Assets
Resources a business owns.

***Auditing**
The examination of financial statements by a certified public accountant in order to express an opinion as to the fairness of presentation.

Basic accounting equation
Assets = Liabilities + Equity.

Bookkeeping
A part of the accounting process that involves only the recording of economic events.

Comprehensive income statement
A financial statement that presents items that are not included in the determination of net income, referred to as other comprehensive income.

Corporation
A business organized as a separate legal entity under jurisdiction corporation law, having ownership divided into transferable shares.

Current value basis
A measurement basis that results in reporting assets and liabilities at current value.

Data analytics
The evaluation of data, often employing both software and statistics, to draw inferences.

Dividend
A distribution of cash or other assets by a corporation to its shareholders.

Economic entity assumption
An assumption that requires that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic entities.

Equity
The ownership claim on a company's total assets.

Ethics
The standards of conduct by which actions are judged as right or wrong, honest or dishonest, fair or not fair.

Expanded accounting equation
Assets = Liabilities + Share Capital—Ordinary + Revenues − Expenses − Dividends.

Expenses
The cost of assets consumed or services used in the process of earning revenue.

Faithful representation
Numbers and descriptions match what really existed or happened—they are factual.

Financial accounting
The field of accounting that provides economic and financial information for investors, creditors, and other external users.

Financial Accounting Standards Board (FASB)
A private organization that establishes generally accepted accounting principles (GAAP) in the United States.

***Forensic accounting**
An area of accounting that uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud.

Generally accepted accounting principles (GAAP)
Common U.S. standards that indicate how to report economic events.

Historical cost basis
A measurement basis that results in companies recording assets and other accounts at their cost.

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

International Accounting Standards Board (IASB)
An accounting standard-setting body that issues standards adopted by many countries outside of the United States.

International Financial Reporting Standards (IFRS)
International accounting standards set by the International Accounting Standards Board (IASB).

Liabilities
Creditor claims on total assets.

***Management consulting**
An area of public accounting ranging from development of accounting and computer systems to support services for marketing projects and merger and acquisition activities.

Managerial accounting
The field of accounting that provides internal reports to help users make decisions about their companies.

Monetary unit assumption
An assumption stating that companies include in the accounting records only transaction data that can be expressed in terms of money.

Net income
The amount by which revenues exceed expenses.

Net loss
The amount by which expenses exceed revenues.

Partnership
A business owned by two or more persons associated as partners.

***Private (or managerial) accounting**
An area of accounting within a company that involves such activities as cost accounting, budgeting, design and support of accounting information systems, and tax planning and preparation.

Proprietorship
A business owned by one person.

***Public accounting**
An area of accounting in which the accountant offers expert service to the general public.

Relevance
Financial information that is capable of making a difference in a decision.

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

Revenues
The gross increase in equity resulting from business activities entered into for the purpose of earning income.

Share capital—ordinary
Amounts paid in by shareholders for the ordinary shares they purchase.

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

Statement of financial position (balance sheet)
A financial statement that reports the assets, liabilities, and equity of a company at a specific date.

***Taxation**
An area of public accounting involving tax advice, tax planning, preparing tax returns, and representing clients before governmental agencies.

Transactions
The economic events of a business that are recorded by accountants.

Practice Multiple-Choice Questions

1. (LO 1) Which of the following is **not** a step in the accounting process?

a. Identification.

b. Economic entity.

c. Recording.

d. Communication.

Solution

2. (LO 1) Which of the following statements about users of accounting information is **incorrect**?

a. Management is an internal user.

b. Taxing authorities are external users.

c. Present creditors are external users.

d. Regulatory authorities are internal users.

Solution

3. (LO 2) The historical cost basis results in:

a. initially recording assets at cost and adjusting when the current value changes.

b. keeping activities of an entity separate and distinct from its owner.

c. recording and reporting assets at their cost.

d. including only transaction data capable of being expressed in terms of money in the accounting records.

Solution

4. (LO 2) Which of the following statements about basic assumptions is **correct**?

a. Basic assumptions are the same as accounting principles.

b. The economic entity assumption states that there should be a particular unit of accountability.

c. The monetary unit assumption enables accounting to measure employee morale.

d. Partnerships are not economic entities.

Solution

5. (LO 2) The three types of business entities are:

a. proprietorships, small businesses, and partnerships.

b. proprietorships, partnerships, and corporations.

c. proprietorships, partnerships, and large businesses.

d. financial, manufacturing, and service companies.

Solution

6. (LO 3) Net income will result during a time period when:

a. assets exceed liabilities.

b. assets exceed revenues.

c. expenses exceed revenues.

d. revenues exceed expenses.

Solution

7. (LO 3) As of December 31, 2025, Stoneland AG has assets of €3,500 and equity of €2,000. What are the liabilities for Stoneland AG as of December 31, 2025?

a. €1,500.

b. €1,000.

c. €2,500.

d. €2,000.

Solution

8. (LO 4) Performing services on account will have the following effects on the components of the basic accounting equation:

a. increase assets and decrease equity.

b. increase assets and increase equity.

c. increase assets and increase liabilities.

d. increase liabilities and increase equity.

Solution

9. (LO 4) Which of the following events is **not** recorded in the accounting records?

a. Equipment is purchased on account.

b. An employee is terminated.

c. A cash investment is made into the business.

d. The company pays a cash dividend.

Solution

10. (LO 4) During 2025, Xia Lin Company's assets decreased ¥500,000 and its liabilities decreased ¥900,000. Its equity therefore:

a. increased ¥400,000.

b. decreased ¥1,400,000.

c. decreased ¥400,000.

d. increased ¥1,400,000.

Solution

11. (LO 4) Payment of an account payable affects the components of the accounting equation in the following way.

a. decreases equity and decreases liabilities.

b. increases assets and decreases liabilities.

c. decreases assets and increases equity.

d. decreases assets and decreases liabilities.

Solution

12. (LO 5) Which of the following statements is **false**?

a. A statement of cash flows summarizes information about the cash inflows (receipts) and outflows (payments) for a specific period of time.

b. A statement of financial position reports the assets, liabilities, and equity at a specific date.

c. An income statement presents the revenues, expenses, assets, and liabilities for a specific period of time.

d. A retained earnings statement summarizes the changes in retained earnings for a specific period of time.

Solution

13. (LO 5) On the last day of the period, Jim Otto Company buys a $900 machine on credit. This transaction will affect the:

a. income statement only.

b. statement of financial position only.

c. income statement and retained earnings statement only.

d. income statement, retained earnings statement, and statement of financial position.

Solution

14. (LO 5) The financial statement that reports assets, liabilities, and equity is the:

a. income statement.

b. retained earnings statement.

c. statement of financial position.

d. statement of cash flows.

Solution

***15. (LO 6)** Services performed by a public accountant include:

a. auditing, taxation, and management consulting.

b. auditing, budgeting, and management consulting.

c. auditing, budgeting, and cost accounting.

d. internal auditing, budgeting, and management consulting.

Solution

Practice Brief Exercises

Use basic accounting equation.

1. **(LO 3)** At the beginning of the year, Ortiz Eyewear had total assets of £900,000 and total liabilities of £440,000. Answer the following questions.

a. If total assets decreased £100,000 during the year and total liabilities increased £80,000 during the year, what is the amount of equity at the end of the year?

b. During the year, total liabilities decreased £100,000 and equity increased £200,000. What is the amount of total assets at the end of the year?

c. If total assets increased £50,000 during the year and equity increased £60,000 during the year, what is the amount of total liabilities at the end of the year?

Solution

Determine effect of transactions on basic accounting equation

2. **(LO 4)** Presented below are three business transactions. List the letters (a), (b), and (c) with columns for assets, liabilities and equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and equity.

a. Purchased equipment on account.

b. Declared and paid cash dividends.

c. Paid expenses in cash.

Solution

Determine effect of transactions on basic accounting equation.

3. **(LO 4)** Follow the same format as in **Practice Brief Exercise 2**. Determine the effect on assets, liabilities, and equity for the following three transactions.

a. Performed accounting services for clients for cash.

b. Borrowed cash from a bank on a note payable.

c. Paid cash for rent for the month.

Solution

Determine where items appear on financial statements.

4. **(LO 5)** Indicate whether the following items would appear on the income statement (IS), statement of financial position (SFP), or retained earnings statement (RES).

a. Dividends.

b. Cash.

c. Salaries and wages expense.

d. Service revenue.

e. Accounts payable.

Solution

Prepare a statement of financial position.

5. **(LO 5)** Presented below in alphabetical order are statement of financial position items for Feagler Gardening at December 31, 2025. Prepare a statement of financial position following the format of Illustration 1.11.

Accounts receivable	€12,500
Cash	38,000
Notes payable	40,000
Share capital—ordinary	10,500

Solution

Practice Exercises

Analyze the effect of transactions.

1. **(LO 3, 4)** Selected transactions for Fabulous Flora are listed below.

1. Issued ordinary shares for cash to start business.
2. Purchased equipment on account.
3. Paid salaries.
4. Billed customers for services performed.
5. Received cash from customers billed in (4).
6. Paid dividends.
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

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

Solution

Analyze the effect of transactions on assets, liabilities, and equity.

2. **(LO 3, 4)** Alma's Payroll Services entered into the following transactions during May 2025.

1. Purchased computers for $15,000 from Bytes of Data on account.
2. Paid $3,000 cash for May rent on storage space.
3. Received $12,000 cash from customers for contracts billed in April.
4. Performed payroll services for Magic Construction Company for $2,500 cash.
5. Paid Northern Ohio Power Co. $7,000 cash for energy usage in May.
6. Shareholders invested an additional $25,000 in the business.
7. Paid Bytes of Data for the computers purchased in (1) above.
8. Incurred advertising expense for May of $900 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

a. an increase in assets and a decrease in assets.

b. an increase in assets and an increase in equity.

c. an increase in assets and an increase in liabilities.

d. a decrease in assets and a decrease in equity.

e. a decrease in assets and a decrease in liabilities.

f. an increase in liabilities and a decrease in equity.

g. an increase in equity and a decrease in liabilities.

Solution

Practice Problem

Prepare a tabular summary and financial statements.

(LO 4, 5) Su Feng opens her own law office, Legal Services Ltd., on July 1, 2025. During the first month of operations, the following transactions occurred (NT$ in thousands).

1. Shareholders invested NT$10,000 in cash in exchange for ordinary shares of Legal Services Ltd.
2. Paid NT$800 for July rent on office space.
3. Purchased office equipment on account NT$3,000.
4. Performed legal services for clients for cash NT$1,500.
5. Borrowed NT$700 cash from a bank on a note payable.
6. Performed legal services for client on account NT$2,000.
7. Paid monthly expenses: salaries NT$500 utilities NT$300, and advertising NT$100.

Instructions

a. Prepare a tabular summary of the transactions. (Prepare using NT$ in thousands.)

b. Prepare the income statement, retained earnings statement, and statement of financial position at July 31, 2025, for Legal Services Ltd. (Prepare using NT$ in thousands.)

Solution

Questions

1. "Accounting is ingrained in our society and it is vital to our economic system." Do you agree? Explain.

2. Identify and describe the steps in the accounting process.

3.

a. Who are internal users of accounting data?

b. How does accounting provide relevant data to these users?

4. What uses of financial accounting information are made by (a) investors and (b) creditors?

5. What are the four most common types of data analytics, and what basic question does each address?

6. "Bookkeeping and accounting are the same." Do you agree? Explain.

7. Remmers Travel Agency purchased land for £85,000 cash on December 10, 2025. At December 31, 2025, the land's value has increased to £93,000. What amount should be reported for land on Remmers' statement of financial position at December 31, 2025? Explain.

8. What is the monetary unit assumption?

9. What is the economic entity assumption?

10. What are the three basic forms of profit-oriented business organizations?

11. Teresa Alvarez is the owner of a successful printing shop. Recently, her business has been increasing, and Teresa has been thinking about changing the organization of her business from a proprietorship to a corporation. Discuss some of the advantages Teresa would enjoy if she were to incorporate her business.

12. What is the basic accounting equation?

13.

a. Define the terms assets, liabilities, and equity.

b. What items affect equity?

14. Which of the following items are liabilities of Designer Jewelry Stores?

a. Cash.

b. Accounts payable.

c. Dividends.

d. Accounts receivable.

e. Supplies.

f. Equipment.

g. Salaries and wages payable.

h. Service revenue.

i. Rent expense.

15. Can a business enter into a transaction in which only the left side of the basic accounting equation is affected? If so, give an example.

16. Are the following events recorded in the accounting records? Explain your answer in each case.

a. The president of the company dies.

b. Supplies are purchased on account.

c. An employee is fired.

17. Indicate how the following business transactions affect the basic accounting equation.

a. Paid cash for janitorial services.

b. Purchased equipment for cash.

c. Received cash in exchange for ordinary shares.

d. Paid accounts payable in full.

18. Listed below are some items found in the financial statements of Min-Seo Promotions. Indicate in which financial statement(s) the following items would appear.

a. Service revenue.

b. Equipment.

c. Advertising expense.

d. Accounts receivable.

e. Retained earnings.

f. Salaries and wages payable.

19. In February 2025, Xia Sun invested an additional £10,000 in Midtown plc. Midtown's accountant, Jon Shin, recorded this receipt as an increase in cash and revenues. Is this treatment appropriate? Why or why not?

20. "A company's net income appears directly on the income statement and the retained earnings statement, and it is included indirectly in the company's statement of financial position." Do you agree? Explain.

21. Jardine plc had an equity balance of £158,000 at the beginning of the period. At the end of the accounting period, the equity balance was £198,000.

a. Assuming no additional investment or distributions during the period, what is the net income for the period?

b. Assuming an additional investment of £13,000 but no distributions during the period, what is the net income for the period?

22. Summarized operations for Carston Gardens for the month of July are as follows.

Revenues recognized: for cash £30,000; on account £70,000.

Expenses incurred: for cash £26,000; on account £40,000.

Indicate for Carston Gardens (a) the total revenues, (b) the total expenses, and (c) net income for the month of July.

23. The basic accounting equation is Assets = Liabilities + Equity. Replacing the words in that equation with numeric amounts, what is **TSMC**'s accounting equation at December 31, 2020? The financial statements of TSMC are presented in Appendix A.

Brief Exercises

Use basic accounting equation.

BE1.1 (LO 3) Presented below is the basic accounting equation (in thousands). Determine the missing amounts.

	Assets	=	Liabilities	+	Equity
a.	¥88,000		¥50,000		?
b.	?		¥45,000		¥70,000
c.	¥94,000		?		¥60,000

Use basic accounting equation.

BE1.2 (LO 3) Given the accounting equation, answer each of the following questions.

a. The liabilities of Shumway Ltd. are £120,000 and the equity is £232,000. What is the amount of Shumway Ltd.'s total assets?

b. The total assets of Shumway Ltd. are £190,000 and its equity is £80,000. What is the amount of its total liabilities?

Use basic accounting equation.

BE1.3 (LO 3) At the beginning of the year, Gilles Plumbers had total assets of €800,000 and total liabilities of €300,000. Answer the following questions. (Note that each situation is independent.)

a. If total assets increased €150,000 during the year and total liabilities decreased €60,000, what is the amount of equity at the end of the year?

b. During the year, total liabilities increased €100,000 and equity decreased €70,000. What is the amount of total assets at the end of the year?

c. If total assets decreased €80,000 and equity increased €120,000 during the year, what is the amount of total liabilities at the end of the year?

Solve expanded accounting equation.

BE1.4 (LO 3) Use the expanded accounting equation to answer each of the following questions.

a. The liabilities of Kumar Company are ₹90,000. Share capital—ordinary is ₹150,000; dividends are ₹40,000; revenues, ₹450,000; and expenses, ₹340,000. What is the amount of Kumar's total assets?

b. The total assets of Kalim Company are ₹57,000. Share capital—ordinary is ₹35,000; dividends are ₹7,000; revenues, ₹52,000; and expenses, ₹35,000. What is the amount of the company's total liabilities?

c. The total assets of Siram Co. are ₹660,000 and its liabilities are equal to two-thirds of its total assets. What is the amount of Siram Co.'s equity?

Identify assets, liabilities, and equity.

BE1.5 (LO 3) Indicate whether each of the following items is an asset (A), liability (L), or part of equity (E).

__________ **a.** Accounts receivable.

__________ **b.** Salaries and wages payable.

__________ **c.** Equipment.

__________ **d.** Supplies.

_________ **e.** Share capital—ordinary.

_________ **f.** Notes payable.

Classify items affecting equity.

BE1.6 (LO 3) Classify each of the following items as dividends (D), revenue (R), or expense (E).

_________ **a.** Advertising expense.

_________ **b.** Service revenue.

_________ **c.** Insurance expense.

_________ **d.** Salaries and wages expense.

_________ **e.** Dividends.

_________ **f.** Rent revenue.

_________ **g.** Utilities expense.

Determine effect of transactions on basic accounting equation.

BE1.7 (LO 4) Presented below are three business transactions. On a sheet of paper, list the letters (a), (b), and (c) with columns for assets, liabilities, and equity. For each column, indicate whether the transactions increased (+), decreased (−), or had no effect (NE) on assets, liabilities, and equity.

a. Purchased supplies on account.

b. Received cash for performing a service.

c. Paid expenses in cash.

Determine effect of transactions on basic accounting equation.

BE1.8 (LO 4) Follow the same format as in BE1.7. Determine the effect on assets, liabilities, and equity of the following three transactions.

a. Shareholders invested cash in the business.

b. Payment of dividends.

c. Received cash from a customer who had previously been billed for services performed.

Determine effect of transactions on equity.

BE1.9 (LO 4) Presented below are three transactions. Mark each transaction as affecting shareholders' investment (I), dividends (D), revenue (R), expense (E), or not affecting equity (NE).

_________ **a.** Received cash for services performed.

_________ **b.** Paid cash to purchase equipment.

_________ **c.** Paid employee salaries.

Prepare a statement of financial position.

BE1.10 (LO 5) In alphabetical order below are statement of financial position items for Grande Ltd. at December 31, 2025. Prepare a statement of financial position, following the format of Illustration 1.11.

Accounts payable	£90,000
Accounts receivable	62,500
Cash	49,000
Share capital—ordinary	21,500

Determine where items appear on financial statements.

BE1.11 (LO 5) Indicate whether the following items would appear on the income statement (IS), statement of financial position (SFP), or retained earnings statement (RES).

_________ **a.** Notes payable.

_________ **b.** Advertising expense.

_________ **c.** Share capital—ordinary.

_________ **d.** Cash.

_________ **e.** Service revenue.

DO IT! Exercises

Review basic concepts.

DO IT! 1.1 **(LO 1)** Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. The three steps in the accounting process are identification, recording, and examination.
2. The accounting process includes the bookkeeping function.
3. Managerial accounting provides reports to help investors and creditors evaluate a company.
4. The two most common types of external users are investors and creditors.
5. Internal users include human resources managers.

Identify building blocks of accounting.

DO IT! 1.2 **(LO 2)** Indicate whether each of the five statements presented below is true or false. If false, indicate how to correct the statement.

1. IFRS are issued by the FASB.
2. The standards of conduct by which actions are judged as loyal or disloyal are ethics.
3. The primary accounting standard-setting body in the United States is the Securities and Exchange Commission (SEC).
4. Using the historical cost basis means that companies record assets at their cost and continue to report them at their cost over the time the assets are held.
5. The monetary unit assumption requires that companies record only transactions that can be measured in money.

Evaluate effects of transactions on equity.

DO IT! 1.3 **(LO 3)** Classify the following items as investment by shareholders (I), dividends (D), revenues (R), or expenses (E). Then indicate whether each item increases or decreases equity.

1. Dividends.
2. Rent revenue.
3. Advertising expense.
4. Shareholders invest cash in business.

Prepare tabular analysis.

DO IT! 1.4 **(LO 4)** Transactions made by Callahan Ltd., a law firm, for the month of March are shown below. Prepare a tabular analysis which shows the effects of these transactions on the accounting equation, similar to that shown in Illustration 1.10.

1. The company performed R20,000 of services for customers, on credit.
2. The company received R20,000 in cash from customers who had been billed for services [in transaction (1)].
3. The company received a bill for R3,200 of advertising but will not pay it until a later date.
4. The company paid a dividend of R5,000 in cash to shareholders.

Determine specific amounts on the financial statements.

DO IT! 1.5 **(LO 5)** Presented below is selected information related to Tsui Repairs at December 31, 2025. Tsui reports financial information monthly (amounts in thousands).

Accounts Payable	HK$ 3,000	Salaries and Wages Expense	HK$16,500
Cash	6,500	Notes Payable	25,000
Advertising Expense	6,000	Rent Expense	10,500
Service Revenue	53,500	Accounts Receivable	13,500
Equipment	29,000	Dividends	7,500

a. Determine the total assets of Tsui Repairs at December 31, 2025.

b. Determine the net income that Tsui Repairs reported for December 2025.

c. Determine the equity of Tsui Repairs at December 31, 2025.

Exercises

Classify the three activities of accounting.

E1.1 **(LO 1)** Genesis Company performs the following accounting tasks during the year.

________ Analyzing and interpreting information.

________ Classifying economic events.

________ Explaining uses, meaning, and limitations of data.

________ Keeping a systematic chronological diary of events.

________ Measuring events in currency (such as euros or yen).

________ Preparing accounting reports.

________ Reporting information in a standard format.

________ Selecting economic activities relevant to the company.

________ Summarizing economic events.

Accounting is "an information system that **identifies**, **records**, and **communicates** the economic events of an organization to interested users."

Instructions

Categorize the accounting tasks performed by Genesis as relating to either the identification (I), recording (R), or communication (C) aspects of accounting.

Identify users of accounting information.

E1.2 **(LO 1)** **a.** The following are users of financial statements.

________ Customers.

________ Tax authorities.

________ Labor unions.

________ Marketing manager.

________ Production supervisor.

________ Financial regulators.

________ Store manager.

________ Suppliers.

________ Vice president of finance.

Instructions

Identify the users as being either **external users** or **internal users**.

b. The following questions could be asked by an internal user or an external user.

________ Can we afford to give our employees a pay raise?

________ Did the company earn a satisfactory income?

________ Do we need to borrow in the near future?

________ How does the company's profitability compare to other companies?

________ What does it cost us to manufacture each unit produced?

________ Which product should we emphasize?

________ Will the company be able to pay its short-term debts?

Instructions

Identify each of the questions as being more likely asked by an **internal user** or an **external user**.

Discuss how using the historical cost basis makes ethical decision-making either easier or more difficult.

E1.3 (LO 2) Angela Manternach, president of Manternach Designs, has instructed Carla Ruden, the head of the accounting department for Manternach Designs, to report the company's land in the company's accounting reports at its current value of €170,000 instead of its cost of €100,000. Manternach says, "Showing the land at €170,000 will make our company look like a better investment when we try to attract new investors next month."

Instructions

Explain the ethical situation involving Carla Ruden, identifying the stakeholders and the alternatives.

Use accounting concepts.

E1.4 (LO 2) The following situations involve accounting principles and assumptions.

1. Julia A/S owns buildings that are worth substantially more than they originally cost. In an effort to provide more relevant information, Julia reports the buildings at their current value in its accounting reports.
2. Dekalb Creations includes in its accounting records only transaction data that can be expressed in terms of money.
3. Omar Shariff, owner of Omar's Oasis, records his personal living costs as expenses of the business.

Instructions

For each of the three situations, determine if the accounting method used is correct or incorrect. If correct, identify which principle or assumption supports the method used. If incorrect, identify which principle or assumption has been violated.

Classify accounts as assets, liabilities, and equity.

E1.5 (LO 3) Diehl Cleaners has the following statement of financial position items.

Accounts payable	Accounts receivable
Cash	Notes payable
Equipment	Salaries and wages payable
Supplies	Share capital—ordinary

Instructions

Classify each item as an asset, liability, or equity.

Analyze the effect of transactions.

E1.6 (LO 4) Selected transactions for Spring Cruises are listed below.

1. Received cash investment from shareholders to start business in exchange for ordinary shares.
2. Paid monthly rent.
3. Purchased equipment on account.
4. Billed customers for services performed.
5. Paid dividends.
6. Received cash from customers billed in (4).
7. Incurred advertising expense on account.
8. Purchased additional equipment for cash.
9. Received cash from customers when service was performed.

Instructions

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

Analyze the effect of transactions on assets, liabilities, and equity.

E1.7 (LO 4) Collins Computer Timeshare entered into the following transactions during May 2025.

1. Purchased computers for R$20,000 from Digital Equipment on account.
2. Paid R$4,000 cash for May rent on storage space.
3. Received R$17,000 cash from customers for contracts billed in April.
4. Performed computer services for Viking Construction for R$4,000 cash.
5. Paid Tri-State Power R$11,000 cash for energy usage in May.
6. Shareholders invested an additional R$29,000 in the business in exchange for ordinary shares.
7. Paid Digital Equipment for the computers purchased in (1) above.
8. Incurred advertising expense for May of R$1,200 on account.

Instructions

Indicate with the appropriate letter whether each of the transactions above results in:

a. An increase in assets and a decrease in assets.
b. An increase in assets and an increase in equity.
c. An increase in assets and an increase in liabilities.
d. A decrease in assets and a decrease in equity.
e. A decrease in assets and a decrease in liabilities.
f. An increase in liabilities and a decrease in equity.
g. An increase in equity and a decrease in liabilities.

Analyze transactions and compute net income.

E1.8 (LO 4, 5) **Writing** An analysis of the transactions made by Kang & Co., a public accounting firm, for the month of August is shown below.

	Assets				= Liabilities +	Equity				
							Retained Earnings			
	Cash	+ Accounts Receivable	+ Supplies	+ Equipment	= Accounts Payable	+ Share Capital	+ Rev.	− Exp.	− Div.	
1.	+£15,000					+£15,000				**Issued Shares**
2.	−2,000			+£5,000	+£3,000					
3.	−750		+£750							
4.	+4,600	+£4,500					+£9,100			**Service Revenue**
5.	−1,500				−1,500					
6.	−2,000								−£2,000	**Dividends**
7.	−650							−£650		**Rent Expense**
8.	+450	−450								
9.	−3,900							−3,900		**Sal./Wages Expense**
10.					+500			−500		**Utilities Expense**

Instructions

a. Describe each transaction that occurred for the month.

b. Determine how much equity increased for the month.

c. Compute the amount of net income for the month.

Prepare financial statements.

E1.9 **(LO 5)** An analysis of transactions for Kang & Co. was presented in E1.8.

Instructions

Prepare an income statement and a retained earnings statement for August and a statement of financial position at August 31, 2025. Assume that August is the company's first month of business.

Determine net income (or loss).

E1.10 **(LO 5)** Kinney A.Ş. had the following assets and liabilities on the dates indicated.

December 31	Total Assets	Total Liabilities
2024	₺400,000	₺250,000
2025	₺460,000	₺300,000
2026	₺590,000	₺400,000

Kinney began business on January 1, 2024, with an investment of ₺100,000.

Instructions

From an analysis of the change in equity during the year, compute the net income (or loss) for:

a. 2024, assuming Kinney's paid ₺12,000 in dividends for the year.

b. 2025, assuming shareholders made an additional investment of ₺34,000 and Kinney paid no dividends in 2025.

c. 2026, assuming shareholders made an additional investment of ₺12,000 and Kinney paid dividends of ₺25,000 in 2026.

Analyze financial statements items.

E1.11 **(LO 5)** Two items are omitted from each of the following summaries of statement of financial position and income statement data for two proprietorships for the year 2025, Greene's Goods and Solar Enterprises.

	Greene's Goods	Solar Enterprises
Beginning of year:		
Total assets	€110,000	€129,000
Total liabilities	85,000	(c)
Total equity	(a)	80,000
End of year:		
Total assets	160,000	180,000
Total liabilities	120,000	50,000
Total equity	40,000	130,000
Changes during year in equity:		
Additional investment	(b)	25,000
Dividends	37,000	(d)
Total revenues	220,000	100,000
Total expenses	175,000	60,000

Instructions

Determine the missing amounts.

Prepare income statement, comprehensive income statement, and retained earnings statement.

E1.12 **(LO 5)** The following information relates to Karen Weigel Co. for the year 2025.

Retained earnings, January 1, 2025	$42,000	Advertising expense	$ 1,800
Dividends paid during 2025	6,000	Rent expense	10,400
Service revenue	63,600	Utilities expense	3,100
Salaries and wages expense	30,200	Other comprehensive income	460

Instructions

After analyzing the data, prepare (a) an income statement and (b) a comprehensive income statement for the year 2025.

Correct an incorrectly prepared statement of financial position.

E1.13 (LO 5) Lynn Dreise is the bookkeeper for Sanculi SpA. Lynn has been trying to get the statement of financial position of Sanculi to balance correctly. Sanculi's statement of financial position is shown as follows.

Sanculi SpA
Statement of Financial Position
December 31, 2025

Assets		**Liabilities**	
Equipment	€48,000	Share capital—ordinary	€50,000
Supplies	8,000	Retained earnings	17,500
Cash	14,000	Accounts payable	16,000
Dividends	5,000	Accounts receivable	(8,500)
Total assets	€75,000	Total equity and liabilities	€75,000

Instructions

Prepare a correct statement of financial position.

Compute net income and prepare a statement of financial position.

E1.14 (LO 5) Bear Park Ltd., a camping ground in the Lake District, has compiled the following financial information as of December 31, 2025.

Revenues during 2025—camping fees	£140,000	Notes payable	£ 60,000
Revenues during 2025—general store	47,000	Expenses during 2025	150,000
Accounts payable	11,000	Supplies on hand	2,500
Cash on hand	20,000	Share capital—ordinary	20,000
Original cost of equipment	105,500	Retained earnings	?
Current value of equipment	140,000		

Instructions

a. Determine Bear Park's net income for 2025.

b. Prepare a statement of financial position for Bear Park Ltd. as of December 31, 2025.

Prepare an income statement and comprehensive income statement.

E1.15 (LO 5) Presented below is financial information related to the 2025 operations of Delgado Cruises SA.

Maintenance and repairs expense	R$ 97,000
Utilities expense	10,000
Salaries and wages expense	144,000
Advertising expense	3,500
Ticket revenue	342,000
Other comprehensive income	4,200

Instructions

Prepare the 2025 income statement and comprehensive income statement for Delgado Cruises SA.

Prepare a retained earnings statement.

E1.16 (LO 5) Presented below is information related to Ling an Co.

Retained earnings, January 1, 2025	£ 23,000
Share capital—ordinary	10,000
Legal service revenue—2025	340,000
Total expenses—2025	211,000
Assets, January 1, 2025	95,000
Liabilities, January 1, 2025	62,000
Assets, December 31, 2025	168,000
Liabilities, December 31, 2025	80,000
Dividends—2025	64,000

Instructions

Prepare the 2025 retained earnings statement for Ling an Co.

Prepare a cash flow statement.

E1.17 (LO 5) This information is for Java Growers for the year ended December 31, 2025 (amounts in thousands).

Cash received from revenues from customers	Rp600,000
Cash received for issuance of ordinary shares	280,000
Cash paid for new equipment	95,000
Cash dividends paid	20,000
Cash paid for expenses	430,000
Cash balance 1/1/25	28,000

Instructions

Prepare the 2025 statement of cash flows for Java Growers.

Identify cash flow activities.

E1.18 (LO 5) The statement of cash flows classifies each transaction as an operating activity, an investing activity, or a financing activity. Operating activities are the types of activities the company performs to generate profits. Investing activities include the purchase of long-lived assets such as equipment or the purchase of investment securities. Financing activities are borrowing money, investments by shareholders, and dividends paid.

Presented below are the following transactions.

1. Shareholders invested €20,000 cash in exchange for ordinary shares.
2. Issued note payable for €12,000 cash.
3. Purchased office equipment for €11,000 cash.
4. Received €15,000 cash for services performed.
5. Paid €1,000 cash for rent.
6. Paid €600 dividend.
7. Paid €5,700 cash for salaries.

Instructions

Classify each of these transactions as operating, investing, or financing activities.

Problems

Analyze transactions and compute net income.

P1.1 (LO 4) On April 1, Julie Chen established Miaoli's Travel Agency. The following transactions were completed during the month.

1. Shareholders invested NT$15,000 cash in the business in exchange for ordinary shares.
2. Paid NT$600 cash for April office rent.

3. Purchased equipment for NT$3,000 cash.
4. Incurred NT$700 of advertising costs for online ads, on account.
5. Paid NT$900 cash for office supplies.
6. Performed services worth NT$10,000: NT$3,000 cash is received from customers, and the balance of NT$7,000 is billed to customers on account.
7. Declared and paid NT$600 dividend.
8. Paid NT$500 of the online advertising amount due in transaction (4).
9. Paid employees' salaries NT$2,500.
10. Received NT$4,000 in cash from customers who have previously been billed in transaction (6).

Instructions

a. Prepare a tabular analysis of the transactions using the following column headings: Cash, Accounts Receivable, Supplies, Equipment, Accounts Payable, Share Capital—Ordinary, Revenues, Expenses, and Dividends.

   Check figures *provide a key number to let you know you are on the right track.*

   a. Total assets NT$20,800

b. From an analysis of the retained earnings columns, compute the net income or net loss for April.

   b. Net income NT$6,200

Analyze transactions and prepare income statement, retained earnings statement, and statement of financial position.

P1.2 **(LO 4, 5)** Ai Fang Co. opened as a new computer services business on August 1, 2025. During August, the following transactions occurred.

1. Shareholders invested ¥20,000 cash in the business in exchange for ordinary shares.
2. Purchased equipment for ¥2,000, paying ¥1,000 in cash and the balance on account.
3. Paid ¥600 cash for August office rent.
4. Purchased ¥500 of supplies on account.
5. Recognized revenue of ¥7,500, of which ¥4,000 is collected in cash with the balance to be collected later.
6. Paid for the supplies purchased in transaction (4).
7. Declared and paid ¥700 dividend.
8. Incurred utility expenses for the month on account ¥270.
9. Paid salaries of ¥2,800 for August.
10. Received ¥2,000 from Standard Bank—money borrowed on a note payable.

Instructions

a. Prepare a tabular analysis of the August transactions. The column headings should be as follows: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Share Capital—Ordinary + Revenues − Expenses − Dividends.

   a. Total assets ¥26,400

b. Prepare an income statement and a retained earnings statement for August, and a statement of financial position at August 31, 2025, for Ai Fang Co.

   b. Net income ¥3,830 Ending retained earnings ¥3,130

Prepare income statement, retained earnings statement, and statement of financial position.

P1.3 **(LO 5)** On May 1, 2025, Park Flying School Ltd., a company that provides flying lessons, was started with an investment of ₩45,000 cash in the business. Following are the assets and liabilities of the company on May 31, 2025, and the revenues and expenses for the month of May (all amounts in thousands).

Cash	₩ 4,500	Notes Payable	₩28,000
Accounts Receivable	7,420	Rent Expense	1,000
Equipment	64,000	Maintenance and Repairs Expense	400
Service Revenue	6,800	Gasoline Expense	2,500
Advertising Expense	500	Utilities Expense	400
Accounts Payable	1,400		

No additional investments were made in May, but the company paid dividends of ₩480,000 during the month.

Instructions

a. Prepare an income statement and a retained earnings statement for the month of May and a statement of financial position at May 31. (Show numbers in thousands.)

a. Net income ₩2,000 Total assets ₩75,920

b. Prepare an income statement and a retained earnings statement for May assuming the following data are not included above: (1) ₩900,000 worth of services were performed and billed but not collected at May 31, and (2) ₩1,500,000 of gasoline expense was incurred but not paid.

b. Net income ₩1,400

Analyze transactions and prepare financial statements.

P1.4 (LO 4, 5) Matt Stiner started a delivery service, Stiner Deliveries Ltd., on June 1, 2025. The following transactions occurred during the month of June.

June	1	Shareholders invested £10,000 cash in the business in exchange for ordinary shares.
	2	Purchased a used van for deliveries for £14,000. Matt paid £2,000 cash and signed a note payable for the remaining balance.
	3	Paid £500 for office rent for the month.
	5	Performed services worth £4,800 on account.
	9	Declared and paid £300 in cash dividends.
	12	Purchased supplies for £150 on account.
	15	Received a cash payment of £1,250 for services performed on June 5.
	17	Purchased gasoline for £100 on account.
	20	Received a cash payment of £1,500 for additional services performed.
	23	Made a cash payment of £500 on the note payable.
	26	Paid £250 for utilities.
	29	Paid for the gasoline purchased on account on June 17.
	30	Paid £1,000 for employee salaries.

Instructions

a. Show the effects of the above transactions on the accounting equation using the following format.

	Assets				=	Liabilities		+	Equity		
										Retained Earnings	
Date	Cash +	Account Receivable +	Supplies +	Equipment	=	Notes Payable +	Accounts Payable	+	Share Capital +	Rev. − Exp. −	Div.

Include margin explanations for any changes in the Retained Earnings account in your analysis.

a. Total assets £25,800

b. Prepare an income statement for the month of June.

b. Net income £4,450

c. Prepare a statement of financial position at June 30, 2025.

c. Cash £8,100

Determine financial statement amounts and prepare retained earnings statement.

P1.5 (LO 4, 5) Writing Financial statement information about four different companies is as follows.

	Crosby Company	Stills Company	Nash Company	Young Company
January 1, 2025				
Assets	HK$ 900,000	HK$1,100,000	(g)	HK$1,500,000
Liabilities	650,000	(d)	HK$ 750,000	(j)
Equity	(a)	500,000	450,000	1,000,000
December 31, 2025				
Assets	(b)	1,370,000	2,000,000	(k)
Liabilities	550,000	750,000	(h)	800,000
Equity	400,000	(e)	1,300,000	1,400,000
Equity changes in year				
Additional investment	(c)	150,000	100,000	150,000
Dividends	100,000	(f)	140,000	100,000
Total revenues	3,500,000	4,200,000	(i)	5,000,000
Total expenses	3,300,000	3,850,000	3,420,000	(l)

Instructions

a. Determine the missing amounts. (*Hint:* For example, to solve for (a), Assets − Liabilities = Equity = HK$250,000.)

b. Prepare the retained earnings statement for Stills Company. Assume beginning retained earnings was HK$200,000.

c. Explain the sequence for preparing financial statements and the interrelationship of the retained earnings statement to the income statement and statement of financial position.

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT1.1 The financial statements of **TSMC** are presented in Appendix A. The complete annual report, including the notes to the financial statements, is available at the company's website.

Instructions

Refer to TSMC's financial statements and answer the following questions. (Use amounts as reported in New Taiwan dollars.)

a. What were TSMC's total assets at December 31, 2020? At December 31, 2019?

b. How much cash (and cash equivalents) did TSMC have on December 31, 2020?

c. What amount of accounts payable did TSMC report on December 31, 2020? On December 31, 2019?

d. What was TSMC's revenue in 2019? In 2020?

e. What is the amount of the change in TSMC's net income from 2019 to 2020?

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT1.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

Refer to the financial statements and answer the following questions.

a. Based on the information contained in these financial statements, determine the following for each company.

   1. Total assets at December 31, 2020.
   2. Accounts (trade) receivable, net at December 31, 2020.
   3. Net sales for year ended December 31, 2020.
   4. Net income (profit) for year ended December 31, 2020.

b. What percentage do receivables represent of total assets for the two companies? What percentage does net income represent of sales (revenue) for the two companies?

Real-World Focus

CT1.3 This exercise will familiarize you with the skills needed (other than accounting skills) to be a successful accountant.

Instructions

Search the Internet for "start here go places" to access resources for future accountants and then answer the following questions.

a. What are the four skill sets that are useful for success in accounting?

b. Why are these skill sets useful for a successful accounting career?

Decision-Making Across the Organization

CT1.4 Anya and Nick Ramon, local golf stars, opened the Chip-Shot Driving Range Ltd. on March 1, 2025, investing £25,000 of their cash savings in the business in exchange for ordinary shares. A caddy shack was constructed for cash at a cost of £8,000, and £800 was spent on golf balls and golf clubs. The company leased five acres of land at a cost of £1,000 per month and paid the first month's rent. During the first month, advertising costs totaled £750, of which £100 was unpaid at March 31, and £500 was paid to members of the high-school golf team for retrieving golf balls. All revenues from customers were deposited in the company's bank account. On March 15, the company paid a total of £1,000 in dividends. A £120 utility bill was received on March 31 but was not paid. On March 31, the balance in the company's bank account was £18,900.

Anya and Nick thought they had a pretty good first month of operations. But, their estimates of profitability ranged from a loss of £6,100 to net income of £2,480.

Instructions

With the class divided into groups, answer the following.

a. How could the Ramons have concluded that the company operated at a loss of £6,100? Was this a valid basis on which to determine net income?

b. How could the Ramons have concluded that the company operated at a net income of £2,480? (*Hint:* Prepare a statement of financial position at March 31.) Was this a valid basis on which to determine net income?

c. Without preparing an income statement, determine the actual net income for March.

d. What was the revenue recognized in March?

Communication Activity

CT1.5 Erin Danielle, the bookkeeper for Liverpool Ltd., has been trying to determine the correct statement of financial position for the company. The company's statement of financial position is shown below.

Liverpool Ltd.
Statement of Financial Position
For the Month Ended December 31, 2025

Assets		**Liabilities**	
Equipment	£25,500	Share capital—ordinary	£20,000
Cash	9,000	Accounts receivable	(5,000)
Supplies	3,000	Retained earnings	4,000
Accounts payable	(8,000)	Notes payable	10,500
	£29,500		£29,500

Instructions

Explain to Erin Danielle in an email why the original statement of financial position is incorrect, and what should be done to correct it.

All About You

CT1.6 Some people are tempted to make their finances look worse to get financial aid. Companies sometimes also manage their financial numbers in order to accomplish certain goals. Earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out bumps in net income. In managing earnings, companies' actions vary from being within the range of ethical activity to being both unethical and illegal attempts to mislead investors and creditors.

Instructions

Provide responses for each of the following questions.

a. Discuss whether you think each of the following actions to increase the chances of receiving financial aid is ethical.
    1. Spend the student's assets and income first, before spending parents' assets and income.
    2. Accelerate necessary expenses to reduce available cash. For example, if you need a new car, buy it before applying for financial aid.
    3. State that a truly financially dependent child is independent.
    4. Have a parent take an unpaid leave of absence for long enough to get below the "threshold" level of income.

b. What are some reasons why a **company** might want to overstate its earnings?

c. What are some reasons why a **company** might want to understate its earnings?

d. Under what circumstances might an otherwise ethical person decide to illegally overstate or understate earnings?

Considering Environmental, Social, and Governance Reporting

CT1.7 Although **Clif Bar & Company** (USA) is not a public company, it does share its financial information with its employees as part of its open-book management approach. Further, although it does not publicly share its financial information, it does provide a different form of an annual report to external users. In this report, the company provides information regarding its sustainability efforts.

Instructions

Go to the Who We Are page at the Clif Bar website and identify the five aspirations.

A Look at U.S. GAAP

LEARNING OBJECTIVE 7

Describe the impact of U.S. accounting standards on global financial reporting.

As indicated in the chapter, IFRSs, which are issued by the IASB, are used by most countries in the world. However, another major standard-setter resides in the United States: the Financial Accounting Standards Board (FASB). Prior to the creation of IFRS, the U.S. accounting standards, referred to as generally accepted accounting principles (GAAP), were used by companies in many countries.

Key Points

While the IASB and the FASB often work together on projects, it appears for the foreseeable future the two Boards will continue to exist independent of one another. It is therefore important for investors, accountants, and students to understand the key similarities and differences that exist between the standards.

Similarities

- GAAP is based on a conceptual framework that is similar to that used to develop IFRS.
- The three common forms of business organization that are presented in the chapter, proprietorships, partnerships, and corporations, are also found in the United States. Because the choice of business organization is influenced by factors such as legal environment, tax rates and regulations, and degree of entrepreneurism, the relative use of each form will vary across countries.
- Transaction analysis is basically the same under IFRS and GAAP but, as you will see in later chapters, the different standards may impact how transactions are recorded.
- Financial frauds have occurred at companies such as **Satyam Computer Services** (IND), **Parmalat** (ITA), and **Royal Ahold** (NLD). They have also occurred at large U.S. companies such as **Enron**, **WorldCom**, and **AIG**.

Differences

- The Sarbanes-Oxley Act (SOX) mandates certain internal controls for large public companies listed on U.S. exchanges. There is a continuing debate as to whether non-U.S. companies should have to comply with this extra layer of regulation. Debate about international companies (non-U.S.) adopting SOX-type standards centers on whether the benefits exceed the costs. The concern is that the higher costs of SOX compliance are making the U.S. securities markets less competitive.
- U.S. regulators have recently eliminated the need for foreign companies that trade shares in U.S. markets to reconcile their accounting with GAAP.
- IFRS tends to be less detailed in its accounting and disclosure requirements than GAAP. This difference in approach has resulted in a debate about the merits of "principles-based" (IFRS) versus "rules-based" (GAAP) standards.

GAAP Practice

GAAP Self-Test Questions

1. Which of the following is **not** a reason why a single set of high-quality international accounting standards would be beneficial?

a. Mergers and acquisition activity.

b. Financial markets.

c. Multinational corporations.

d. GAAP is widely considered to be a superior reporting system.

Answer

2. The Sarbanes-Oxley Act determines:

a. international tax regulations.

b. internal control standards as enforced by the IASB.

c. internal control standards of U.S. publicly traded companies.

d. U.S. tax regulations.

Answer

3. IFRS is considered to be more:

a. principles-based and less rules-based than GAAP.

b. rules-based and less principles-based than GAAP.

c. detailed than GAAP.

d. None of the answer choices is correct.

Answer

4. Which of the following statements is **false**?

a. GAAP is based on a conceptual framework that is similar to that used to develop IFRS.

b. FASB and the IASB are working on a joint project related to the conceptual framework.

c. Non-U.S. companies that trade shares in U.S. markets must reconcile their accounting with GAAP.

d. Proprietorships, partnerships, and corporations are also found in countries that use IFRS.

Answer

5. Which of the following is **true**?

a. Financial frauds have not occurred in U.S. companies because GAAP has detailed accounting and disclosure requirements.

b. Transaction analysis is basically the same under GAAP and IFRS.

c. IFRS companies have agreed to adopt the Sarbanes-Oxley Act related to internal control in 2025.

d. Foreign companies that trade shares in U.S. markets must reconcile their accounting with the FASB.

Answer

GAAP Exercises

GAAP1.1 Who are the two key international players in the development of international accounting standards? Explain their role.

GAAP1.2 What might explain the fact that different accounting standard-setters have developed accounting standards that are sometimes quite different in nature?

GAAP1.3 What is the benefit of a single set of high-quality accounting standards?

GAAP1.4 Discuss the potential advantages and disadvantages that countries outside the United States should consider before adopting regulations, such as those in the Sarbanes-Oxley Act, that increase corporate internal control requirements.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP1.5 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

Refer to Apple's financial statements to answer the following questions.

a. What were Apple's total assets at September 26, 2020? At September 28, 2019?

b. How much cash did Apple have on September 26, 2020?

c. What amount of accounts payable did Apple report on September 26, 2020? On September 28, 2019?

d. What were Apple's total revenues in 2020? In 2019? In 2018?

e. What is the amount of the change in Apple's net income from 2019 to 2020?

Note

1 The appendix to this chapter describes job opportunities for accounting majors and explains why accounting is such a popular major.

2 The origins of accounting are generally attributed to the work of Luca Pacioli, an Italian Renaissance mathematician. Pacioli was a close friend and tutor to Leonardo da Vinci and a contemporary of Christopher Columbus. In his 1494 text *Summa de Arithmetica*, *Geometria*, *Proportione et Proportionalite*, Pacioli described a system to ensure that financial information was recorded efficiently and accurately.

3 IFRS uses both the term income and the term revenue to refer to the increase in equity resulting from business activities entered into for the purpose of earning income. To avoid confusion, we will use the term revenue consistently in this text.

4 For the illustrative equations that follow, we use the general account title "Share Capital" instead of "Share Capital—Ordinary" for space considerations.

5 Most companies prepare a statement of changes in equity, which includes the information for the retained earnings statement along with the sources of the changes in the other equity accounts.

CHAPTER 2
The Recording Process

Eva-Katalin/E+/Getty Images

Chapter Preview

In Chapter 1, we analyzed business transactions in terms of the accounting equation, and we presented the cumulative effects of these transactions in tabular form. Imagine a company like **Bank of Taiwan** (TWN) (as in the following Feature Story) using the same tabular format as Softbyte SA to keep track of its transactions. In a single day, Bank of Taiwan engages in thousands of business transactions. To record each transaction this way would be impractical, expensive, and unnecessary. Instead, companies use a set of procedures and records to keep track of transaction data more easily. This chapter introduces and illustrates these basic procedures and records.

Feature Story

Accidents Happen

How organized are you financially? Take a short quiz. Answer *yes* or *no* to each question:

- Does your wallet contain so many cash machine receipts that you've been declared a walking fire hazard?
- Do you verify the accuracy of your bank account about as often as you clean the space behind your refrigerator?
- Do you wait until your debit card is denied before checking the status of your funds?

If you think it is hard to keep track of the many transactions that make up *your* life, imagine what it is like for a major company like **Bank of Taiwan (BOT)** (TWN). If you had your life savings invested at BOT, you might be just slightly displeased if, when you checked your balance online, a message appeared on the screen indicating that your account information was lost.

To ensure the accuracy of your balance and the security of your funds, BOT, like all other companies large and small, relies on a sophisticated accounting information system. That's not to say that BOT or any other company is error-free. In fact, if you've ever overdrawn your bank account because you failed to track your debit card purchases properly, you may take some comfort from one accountant's mistake at **Fidelity Investments** (USA), one of the largest mutual fund investment firms in the world. The accountant failed to include a minus sign while doing a calculation, making what was actually a $1.3 billion loss look like a $1.3 billion—yes, *billion*—gain! Fortunately, like most accounting errors, it was detected before any real harm was done.

No one expects that kind of mistake at a company like Fidelity, which has sophisticated computer systems and top investment managers. In explaining the mistake to shareholders, a spokesperson wrote, "Some people have asked how, in this age of technology, such a mistake could be made. While many of our processes are computerized, accounting systems are complex and dictate that some steps must be handled manually by our managers and accountants, and people can make mistakes."

Chapter Outline

LEARNING OBJECTIVES	REVIEW	PRACTICE
LO 1 Describe how accounts, debits, and credits are used to record business transactions.	• The account • Debits and credits • Equity relationships • Summary of debit/credit rules	DO IT! 1 Normal Account Balances
LO 2 Indicate how a journal is used in the recording process.	• The recording process • The journal	DO IT! 2 Recording Business Activities
LO 3 Explain how a ledger and posting help in the recording process.	• The ledger • Posting • Chart of accounts • The recording process illustrated • Summary illustration of journalizing and posting	DO IT! 3 Posting
LO 4 Prepare a trial balance.	• Limitations of a trial balance • Locating errors • Currency signs and underlining	DO IT! 4 Trial Balance

Go to the Review and Practice section at the end of the chapter for a review of key concepts and practice applications with solutions.
Additional tutorials and practice opportunities are available in the Wiley online course.

2.1 Accounts, Debits, and Credits

LEARNING OBJECTIVE 1

Describe how accounts, debits, and credits are used to record business transactions.

The Account

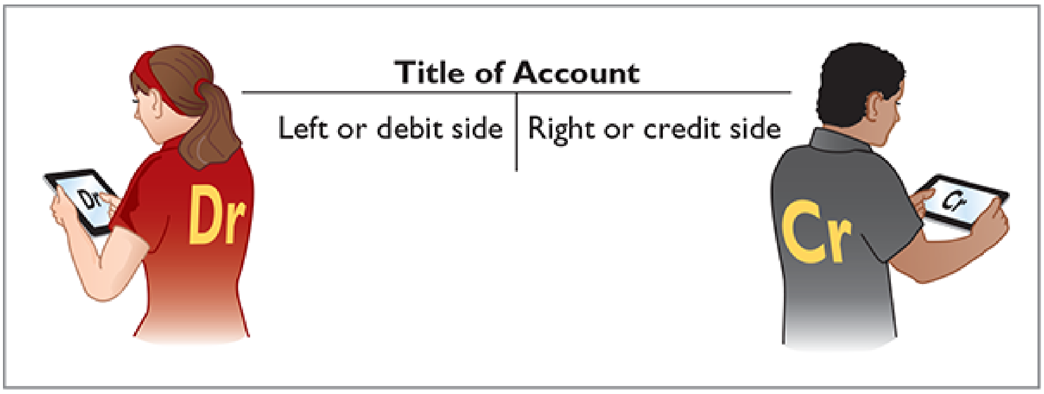
An **account** is an individual accounting record of increases and decreases in a specific asset, liability, or equity item. For example, Softbyte SA (the company discussed in Chapter 1) would have separate accounts for Cash, Accounts Receivable, Accounts Payable, Service Revenue, Salaries and Wages Expense, and so on. (Note that whenever we are referring to a specific account, we capitalize the name.)

In its simplest form, an account consists of three parts:

1. A title.
2. A left or debit side.
3. A right or credit side.

Because the format of an account resembles the letter T, we refer to it as a **T-account**. **Illustration 2.1** shows the basic form of an account.

ILLUSTRATION 2.1 Basic form of account



We use this form often throughout this text to explain basic accounting relationships.

Debits and Credits

The term **debit** indicates the left side of an account, and **credit** indicates the right side.

- They are commonly abbreviated as **Dr.** for debit and **Cr.** for credit. They **do not** mean increase or decrease, as is commonly thought.
- We use the terms **debit** and **credit** repeatedly in the recording process to describe **where** entries are made in accounts.
- For example, the act of entering an amount on the left side of an account is called **debiting** the account. Making an entry on the right side is **crediting** the account.

When comparing the totals of the two sides, an account shows a **debit balance** if the total of the debit amounts exceeds the credits. An account shows a **credit balance** if the credit amounts exceed the debits. Note the position of the debit side and credit side in Illustration 2.1.

The procedure of recording debits and credits in an account is shown in **Illustration 2.2** for the transactions affecting the Cash account of Softbyte SA. The data are taken from the Cash column of the tabular summary in Illustration 1.10.

ILLUSTRATION 2.2 Tabular summary and account form for Softbyte's Cash account

Tabular Summary

Cash
€15,000
–7,000
1,200
1,500
–1,700
–250
600
–1,300
€ 8,050

Account Form

Cash			
(Debits)	15,000	(Credits)	7,000
	1,200		1,700
	1,500		250
	600		1,300
Balance (Debit)	8,050		

Every positive item in the tabular summary represents a receipt of cash. Every negative amount represents a payment of cash. **Notice that in the account form, we record the increases in cash as debits and the decreases in cash as credits.** For example, the €15,000 receipt of cash (in blue) is debited to Cash, and the –€7,000 payment of cash (in red) is credited to Cash.

- Having increases on one side and decreases on the other reduces recording errors and helps in determining the totals of each side of the account as well as the account balance.
- The balance is determined by netting the two sides (subtracting one amount from the other).

Here, the account balance, a debit of €8,050, indicates that Softbyte had €8,050 more increases than decreases in cash. In other words, Softbyte started with a balance of zero and now has €8,050 in its Cash account.

Debit and Credit Procedure

In Chapter 1, you learned the effect of a transaction on the basic accounting equation.

- Each transaction must affect two or more accounts to keep the basic accounting equation in balance. In addition, for each transaction, debits must equal credits.
- The equality of debits and credits provides the basis for the **double-entry system** of recording transactions (see **Helpful Hint**).

> **HELPFUL HINT**
>
> **Rules for accounting for specific events sometimes differ across countries. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.**

Under the double-entry system, the dual (two-sided) effect of each transaction is recorded in appropriate accounts. This system provides a logical method for recording transactions and also helps ensure the accuracy of the recorded amounts as well as the detection of errors. If every transaction is recorded with equal debits and credits, the sum of all the debits to the accounts must equal the sum of all the credits.

The double-entry system for determining the equality of the accounting equation is much more efficient than the plus/minus procedure used in Chapter 1. The following discussion illustrates debit and credit procedures in the double-entry system.

Dr./Cr. Procedures for Assets and Liabilities

In Illustration 2.2 for Softbyte, increases in Cash—an asset—are entered on the left side, and decreases in Cash are entered on the right side.

- We know that both sides of the basic equation (Assets = Liabilities + Equity) must be equal.
- It therefore follows that increases and decreases in liabilities have to be recorded **opposite from** increases and decreases in assets.
- Thus, increases in liabilities are entered on the right or credit side, and decreases in liabilities are entered on the left or debit side.

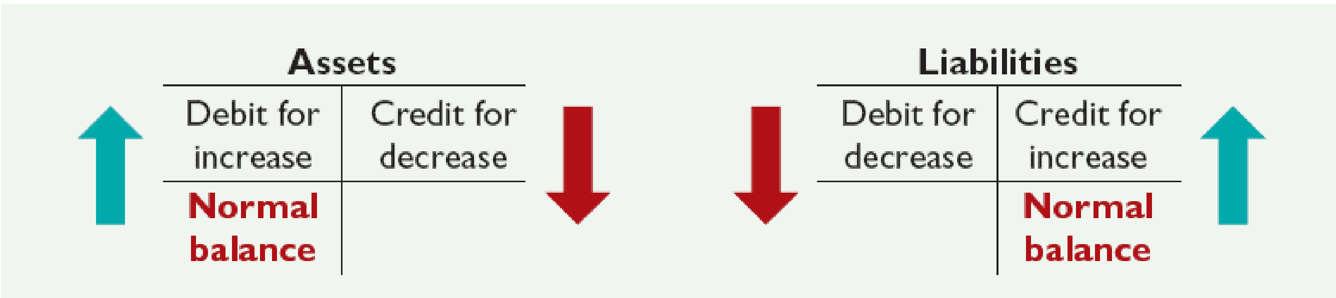
The effects that debits and credits have on assets and liabilities are summarized in **Illustration 2.3**.

ILLUSTRATION 2.3 Debit and credit effects—assets and liabilities

Debits	Credits
Increase assets	Decrease assets
Decrease liabilities	Increase liabilities

Asset accounts normally show debit balances. That is, debits to a specific asset account should exceed credits to that account. Likewise, **liability accounts normally show credit balances**. That is, credits to a liability account should exceed debits to that account. The **normal balance** of an account is on the side where an increase in the account is recorded. **Illustration 2.4** shows the normal balances for assets and liabilities.

ILLUSTRATION 2.4 Normal balances—assets and liabilities



Knowing the normal balance in an account may help you trace errors. For example, a credit balance in an asset account such as Land or a debit balance in a liability account such as Salaries and Wages Payable usually indicates an error. Occasionally, though, an abnormal balance may be correct. The Cash account, for example, will have a credit balance when a company has overdrawn its bank balance by spending more than it has in its account.

Dr./Cr. Procedures for Equity

As Chapter 1 indicated, shareholders' investments and revenues increase equity. Dividends and expenses decrease equity. In a double-entry system, companies keep accounts for each of these types of transactions: share capital—ordinary, retained earnings, dividends, revenues, and expenses.

Share Capital—Ordinary

Companies issue share capital—ordinary in exchange for the owners' investment paid in to the company.

- Credits increase the Share Capital—Ordinary account, and debits decrease it.
- When an owner invests cash in the business in exchange for ordinary shares, the company debits (increases) Cash and credits (increases) Share Capital—Ordinary.

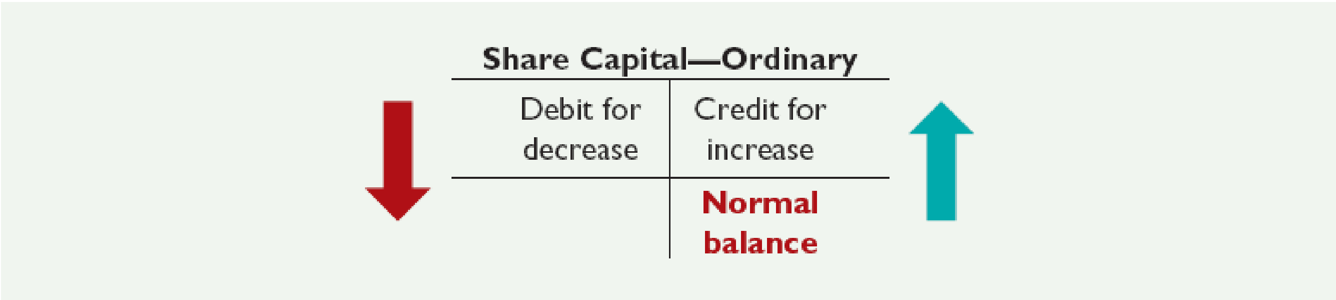
Illustration 2.5 shows the rules of debit and credit for the Share Capital–Ordinary account.

ILLUSTRATION 2.5 Debit and credit effects—share capital—ordinary

Debits	Credits
Decrease Share Capital—Ordinary	Increase Share Capital—Ordinary

We can diagram the normal balance in Share Capital—Ordinary as shown in Illustration 2.6.

ILLUSTRATION 2.6 Normal balance—share capital—ordinary



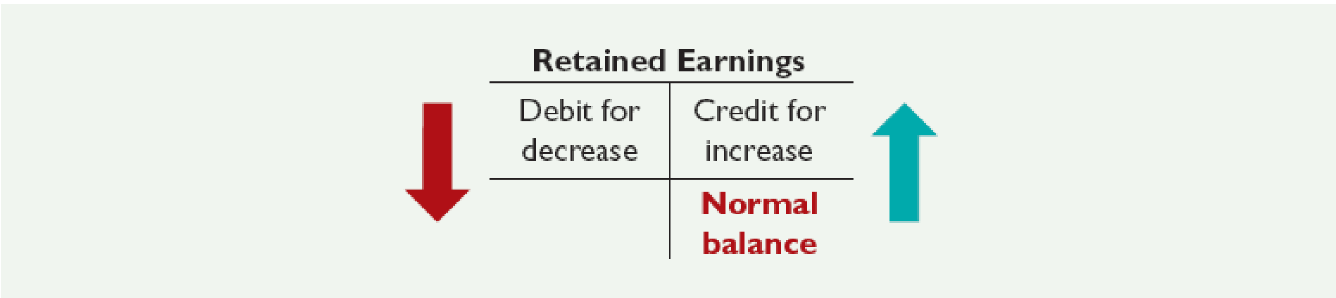
Retained Earnings

Retained earnings is net income that is kept (retained) in the business.

- Retained Earnings represents the portion of equity that the company has accumulated through the profitable operation of the business.
- Credits (net income) increase the Retained Earnings account, and debits (dividends or net losses) decrease it, as Illustration 2.7 shows (see Helpful Hint).

> **HELPFUL HINT**
>
> **The rules for debit and credit and the normal balances of share capital—ordinary and retained earnings are the same as for liabilities.**

ILLUSTRATION 2.7 Debit and credit effects and normal balance—retained earnings



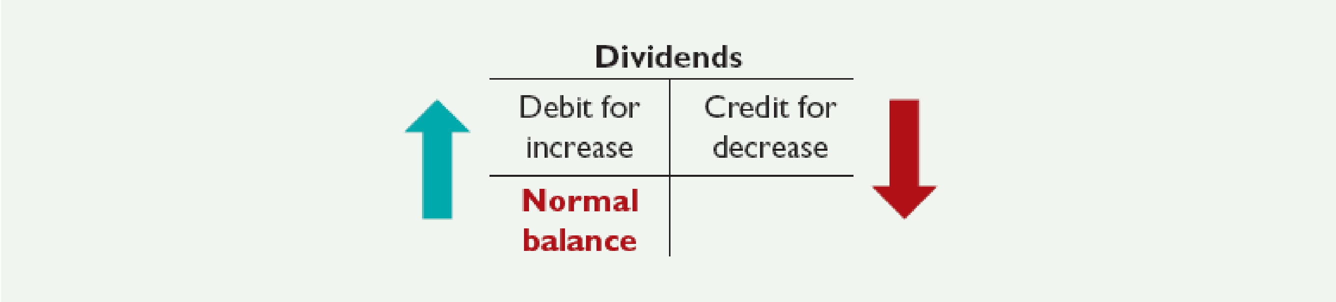
Dividends

A dividend is a company's distribution to its shareholders. The most common form of a distribution is a **cash dividend.**

- Dividends reduce the shareholders' claims on retained earnings.
- Debits increase the Dividends account, and credits decrease it.

Illustration 2.8 shows that this account normally has a debit balance.

ILLUSTRATION 2.8 Debit and credit effect and normal balance—dividends



Revenues and Expenses

The purpose of earning revenues is to benefit the shareholders of the business.

- When a company recognizes revenues, equity increases. Therefore, **the effect of debits and credits on revenue accounts is the same as their effect on Retained Earnings**. That is, revenue accounts are increased by credits and decreased by debits (see Helpful Hint).
- Expenses have the opposite effect. Expenses decrease equity. Since expenses decrease net income and revenues increase it, it is logical that the increase and decrease sides of expense accounts should be the opposite of revenue accounts. Thus, expense accounts are increased by debits and decreased by credits.

> **HELPFUL HINT**
>
> **Because revenues increase equity, a revenue account has the same debit/credit rules as the Retained Earnings account. Expenses have the opposite effect.**

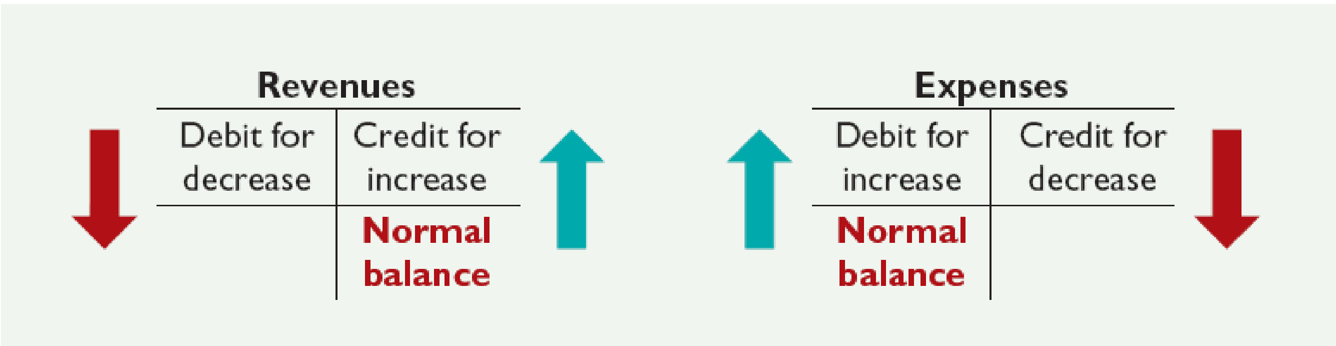
Illustration 2.9 shows the rules of debits and credits for revenues and expenses.

ILLUSTRATION 2.9 Debit and credit effects—revenues and expenses

Debits	Credits
Decrease revenues	Increase revenues
Increase expenses	Decrease expenses

Credits to revenue accounts should exceed debits. Debits to expense accounts should exceed credits. Thus, revenue accounts normally show credit balances, and expense accounts normally show debit balances. Illustration 2.10 shows the normal balances for revenues and expenses.

ILLUSTRATION 2.10 Normal balances—revenues and expenses



Investor Insight

CTBC Brothers

Keeping Score

Mandy Cheng/AFP/
Getty Images

The **CTBC Brothers** (TWN) baseball team probably has these major revenue and expense accounts:

Revenues	Expenses
Admissions (ticket sales)	Players' salaries
Concessions	Administrative salaries
Television and radio	Travel
Advertising	Stadium maintenance

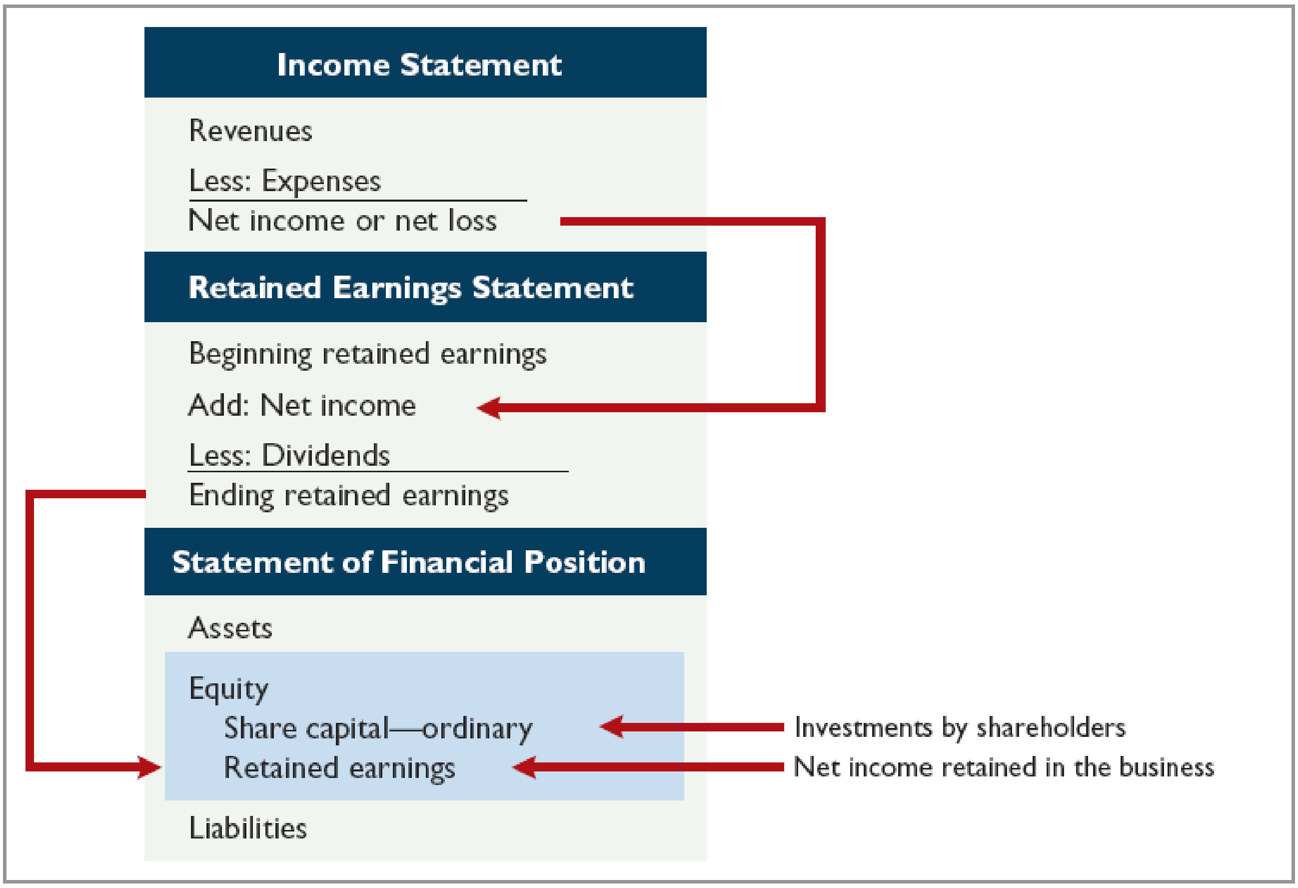
Do you think that the Manchester United (GBR) football (soccer) club would be likely to have the same major revenue and expense accounts as CTBC Brothers?

Answer

Equity Relationships

As Chapter 1 indicated, companies report share capital—ordinary and retained earnings in the equity section of the statement of financial position. They report dividends on the retained earnings statement. And they report revenues and expenses on the income statement. Dividends, revenues, and expenses are eventually transferred to retained earnings at the end of the period. As a result, a change in any one of these three items affects equity. **Illustration 2.11** shows the relationships related to equity.

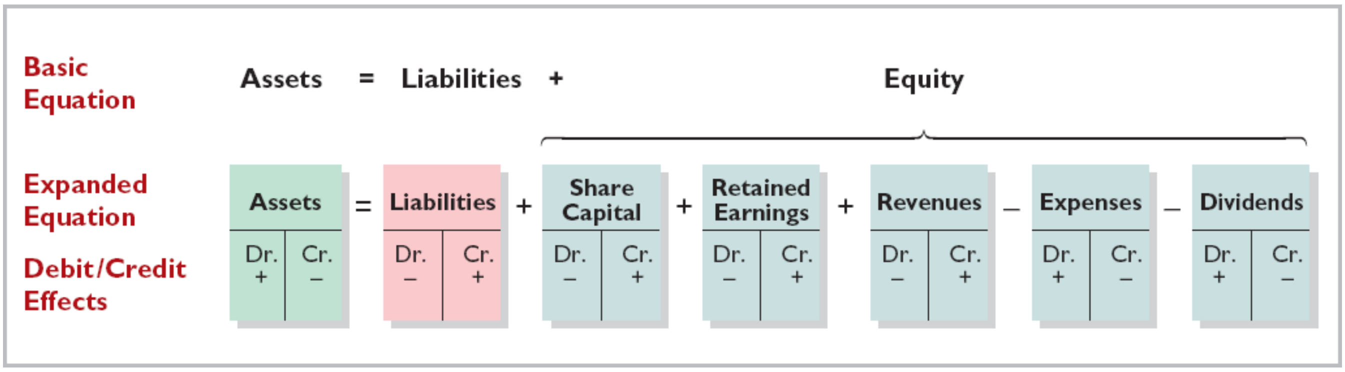
ILLUSTRATION 2.11 **Equity relationships**



Summary of Debit/Credit Rules

Illustration 2.12 shows a summary of the debit/credit rules and effects on each type of account. Study this diagram carefully. It will help you understand the fundamentals of the double-entry system.

ILLUSTRATION 2.12 **Summary of debit/credit rules**



DO IT! 1

Normal Account Balances

Julie Loeng has just rented space in a shopping mall. In this space, she will open a hair salon to be called "Hair It Is." A friend has advised Julie to set up a double-entry set of accounting records in which to record all of her business transactions.

Identify the statement of financial position accounts that Julie will likely need to record the transactions needed to open her business. Indicate whether the normal balance of each account is a debit or a credit.

ACTION PLAN

- **Determine the types of accounts needed. Julie will need asset accounts for each different type of asset invested in the business and liability accounts for any debts incurred.**
- **Understand the types of equity accounts. Only Share Capital—Ordinary will be needed when Julie begins the business. Other equity accounts will be needed later.**

Solution

Related exercise material: BE2.1, BE2.2, DO IT! 2.1, E2.1, E2.2, E2.6, **and** E2.7.

2.2 The Journal

LEARNING OBJECTIVE 2

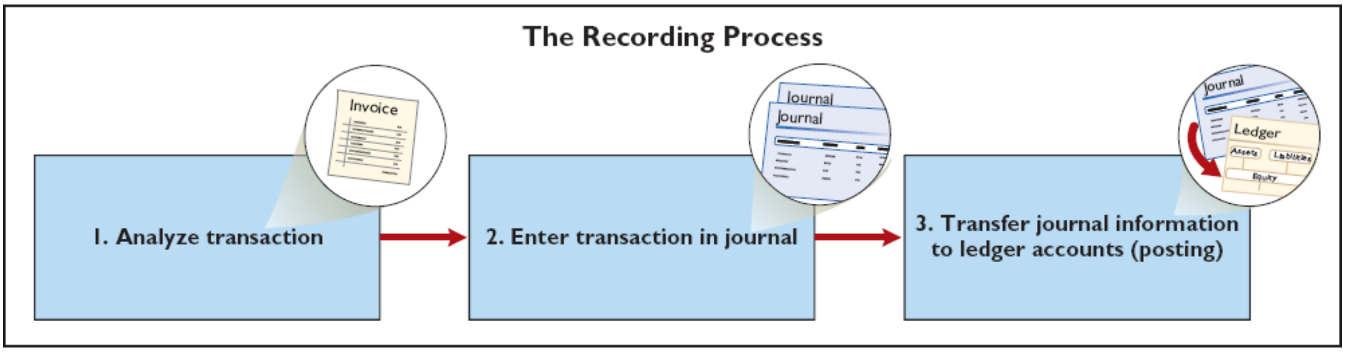
Indicate how a journal is used in the recording process.

The Recording Process

Although it is possible to enter transaction information directly into the accounts, few businesses do so. Practically every business uses the basic steps shown in Illustration 2.13 in the recording process (an integral part of the accounting cycle):

1. Analyze each transaction in terms of its effect on the accounts.
2. Enter the transaction information in a journal.
3. Transfer the journal information to the appropriate accounts in the ledger.

ILLUSTRATION 2.13 **The recording process**



The steps in the recording process occur repeatedly (see Ethics Note). In Chapter 1, we illustrated the first step, the analysis of transactions, and will give further examples in this and later chapters. The other two steps in the recording process are explained in the next sections.

ETHICS NOTE

International Outsourcing Services, LLC was accused of submitting fraudulent store coupons to companies for reimbursement of as much as $250 million. Use of proper business documents reduces the likelihood of fraudulent activity.

The Journal

Companies initially record transactions in chronological order (the order in which they occur). Thus, the **journal** is referred to as the book of original entry. For each transaction, the journal shows the debit and credit effects on specific accounts (see **Helpful Hint**).

HELPFUL HINT

In a computerized system, journals are kept as files, and accounts are recorded in electronic databases.

Companies may use various kinds of journals, but every company has the most basic form of journal, a **general journal**. Typically, a general journal has spaces for dates, account titles and explanations, references, and two amount columns. See the format of the journal in Illustration 2.14. *Whenever we use the term "journal" in this text, we mean the general journal unless we specify otherwise.*

The journal makes several significant contributions to the recording process:

1. It discloses in one place the **complete effects of a transaction**.
2. It provides a **chronological record** of transactions.
3. It helps to **prevent or locate errors** because the debit and credit amounts for each entry can be easily compared.

Journalizing

Entering transaction data in the journal is known as **journalizing**. Companies make separate journal entries for each transaction. A complete entry consists of (1) the date of the transaction, (2) the accounts and amounts to be debited and credited, and (3) a brief explanation of the transaction.

Illustration 2.14 shows the technique of journalizing, using the first two transactions of Softbyte SA. Recall that on September 1, shareholders invested €15,000 cash in the corporation in exchange for ordinary shares, and Softbyte purchased computer equipment for €7,000 cash. The number J1 indicates that these two entries are recorded on the first page of the journal. **Illustration 2.14** shows the standard form of journal entries for these two transactions. (The boxed numbers correspond to explanations in the list below the illustration.)

ILLUSTRATION 2.14 Technique of journalizing

GENERAL JOURNAL J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025		5		
Sept. 1	2 Cash		15,000	
1	3 Share Capital—Ordinary			15,000
	4 (Issued shares for cash)			
1	Equipment		7,000	
	Cash			
	(Purchase of equipment for cash)			7,000

1 The date of the transaction is entered in the Date column.

2 The debit account title (that is, the account to be debited) is entered first at the extreme left margin of the column headed "Account Titles and Explanation," and the amount of the debit is recorded in the Debit column.

3 The credit account title (that is, the account to be credited) is indented and entered on the next line in the column headed "Account Titles and Explanation," and the amount of the credit is recorded in the Credit column.

4 A brief explanation of the transaction appears on the line below the credit account title. A space is left between journal entries. The blank space separates individual journal entries and makes the entire journal easier to read.

5 The column titled Ref. (which stands for Reference) is left blank when the journal entry is made. This column is

used later when the journal entries are transferred to the individual accounts.

It is important to use correct and specific account titles in journalizing. Erroneous account titles lead to incorrect financial statements. However, some flexibility exists initially in selecting account titles.

- The main criterion is that each title must appropriately describe the content of the account.
- Once a company chooses the specific title to use, it should record under that account title all later transactions involving the account. *In homework problems, you should use specific account titles when they are given.*
- When account titles are not given, you may select account titles that identify the nature and content of each account. The account titles used in journalizing should not contain explanations such as Cash Paid or Cash Received.

Simple and Compound Entries

Some entries involve only two accounts, one debit and one credit. (See, for example, the entries in Illustration 2.14.) This type of entry is called a **simple entry**. Some transactions, however, require more than two accounts in journalizing. An entry that requires three or more accounts is a **compound entry**.

To illustrate, assume that on July 1, Butler Shipping purchases a delivery truck costing £14,000. It pays £8,000 cash now and agrees to pay the remaining £6,000 on account (to be paid later). **Illustration 2.15** shows the compound entry.

ILLUSTRATION 2.15 Compound journal entry

GENERAL JOURNAL J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025				
July 1	Equipment		14,000	
	Cash			8,000
	Accounts Payable			6,000
	(Purchased truck for cash with balance on account)			

In a compound entry, the standard format requires that all debits be listed before the credits.

Accounting Across the Organization

Hain Celestial Group

It Starts with the Transaction

Keith Homan/
Shutterstock

Recording financial transactions in a company's records should be straightforward. If a company determines that a transaction involves revenue, it records revenue. If it has an expense, then it records an expense. However, sometimes this is difficult to do.

For example, for more than a year, **Hain Celestial Group** (USA) (an organic food company) did not provide income information to investors and regulators. The reason given—the organic food company discovered revenue irregularities and said it could not release financial results until it determined when and how to record revenue for certain transactions. When Hain missed four deadlines for reporting earnings information, the food company suffered a 34% drop in its share price. As one analyst noted, it is hard to fathom why a seemingly simple revenue recognition issue took one year to resolve.

In other situations, outright fraud may occur. For example, regulators charged **Obsidian Energy** (CAN) for fraudulently moving millions of dollars in expenses from operating expenses to capital expenditure accounts. By understating reported operating expenses, Obsidian made it appear that it was managing its costs efficiently as well as increasing its income.

These examples demonstrate that "getting the basic transaction right" is the foundation for relevant and reliable financial statements. Starting with an incorrect or inappropriate transaction leads to distortions in the financial statements.

Sources: Based on Shawn Tully, "The Mystery of Hain Celestial's Accounting," *Fortune.com* (August 20, 2016); and Kelly Cryderman, "U.S. Charges Obsidian, Formerly Penn West, with Accounting Fraud," *The Globe and Mail* (June 28, 2017).

Why is it important for companies to record financial transactions completely and accurately?

Answer

DO IT! 2

Recording Business Activities

As president and sole shareholder, Julie Loeng engaged in the following activities in establishing her beauty salon, Hair It Is.

1. Opened a bank account in the name of Hair It Is and deposited €20,000 of her own money in this account in exchange for ordinary shares.
2. Purchased equipment on account (to be paid in 30 days) for a total cost of €4,800.
3. Interviewed three applicants for the position of beautician.

In what form (type of record) should Hair It Is record these three activities? Prepare the entries to record the transactions.

ACTION PLAN

- **Understand which activities need to be recorded and which do not. Any that have economic effect should be recorded in a journal.**
- **Analyze the effects of transactions on asset, liability, and equity accounts.**

Solution

Related exercise material: **BE2.3**, **BE2.4**, **BE2.5**, **BE2.6**, **DO IT! 2.2**, **E2.3**, **E2.4**, **E2.5**, **E2.6**, **E2.7**, **E2.8**, **and E2.9**.

2.3 The Ledger and Posting

LEARNING OBJECTIVE 3

Explain how a ledger and posting help in the recording process.

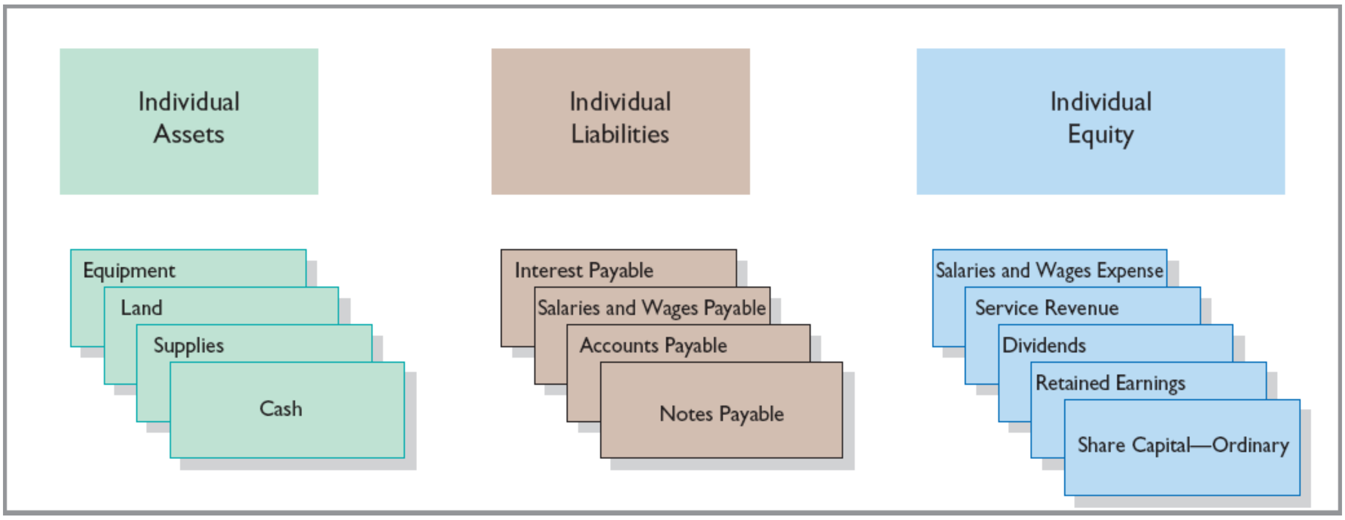
The Ledger

The entire group of accounts maintained by a company is the **ledger**.

- The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances.
- Companies may use various kinds of ledgers, but every company has a general ledger.
- A **general ledger** contains all the asset, liability, and equity accounts, as shown in **Illustration 2.16**. *Whenever we use the term "ledger" in this text, we are referring to the general ledger unless we specify otherwise.*

The ledger provides the balance in each of the accounts. For example, the Cash account shows the amount of cash available to meet current obligations. The Accounts Receivable account shows amounts due from customers. Accounts Payable shows amounts owed to creditors. Each account is numbered for easier identification.

ILLUSTRATION 2.16 **The general ledger, which contains all of a company's accounts**



Ethics Insight

Credit Suisse Group

A Convenient Overstatement

Nuno Silva/
Getty Images

Sometimes a company's investment securities suffer a permanent decline in value below their original cost. When this occurs, the company is supposed to reduce the recorded value of the securities on its statement of financial position ("write them down" in common financial lingo) and record a loss. It appears, however, that during the financial crisis of 2008, employees at some financial institutions chose to look the other way as the value of their investments skidded.

A number of securities traders that worked for the investment bank **Credit Suisse Group** (CHE) were charged with intentionally overstating the value of securities that had suffered declines of approximately $2.85 billion. One reason that they may have been reluctant to record the losses is out of fear that the company's shareholders and clients would panic if they saw the magnitude of the losses. However, personal self-interest might have been equally to blame—the bonuses of the traders were tied to the value of the investment securities.

> **Source:** Based on S. Pulliam, J. Eaglesham, and M. Siconolfi, "U.S. Plans Changes on Bond Fraud," *Wall Street Journal Online* (February 1, 2012).

What incentives might employees have to overstate the value of these investment securities on the company's financial statements?

Answer

Standard Form of Account

The simple T-account form used in accounting texts is often very useful for illustration purposes. However, in practice, the account forms used in ledgers are much more structured. Illustration 2.17 shows a typical form, using assumed data from a cash account.

ILLUSTRATION 2.17 Three-column form of account

CASH NO.101

Date		Explanation	Ref.	Debit	Credit	Balance
2025						
June	1			25,000		25,000
	2				8,000	17,000
	3			4,200		21,200
	9			7,500		28,700
	17				11,700	17,000
	20				250	16,750
	30				7,300	9,450

This format is called the **three-column form of account**. It has three money columns—debit, credit, and balance. The balance in the account is determined after each transaction. Companies use the explanation space and reference columns to provide special information about the transaction.

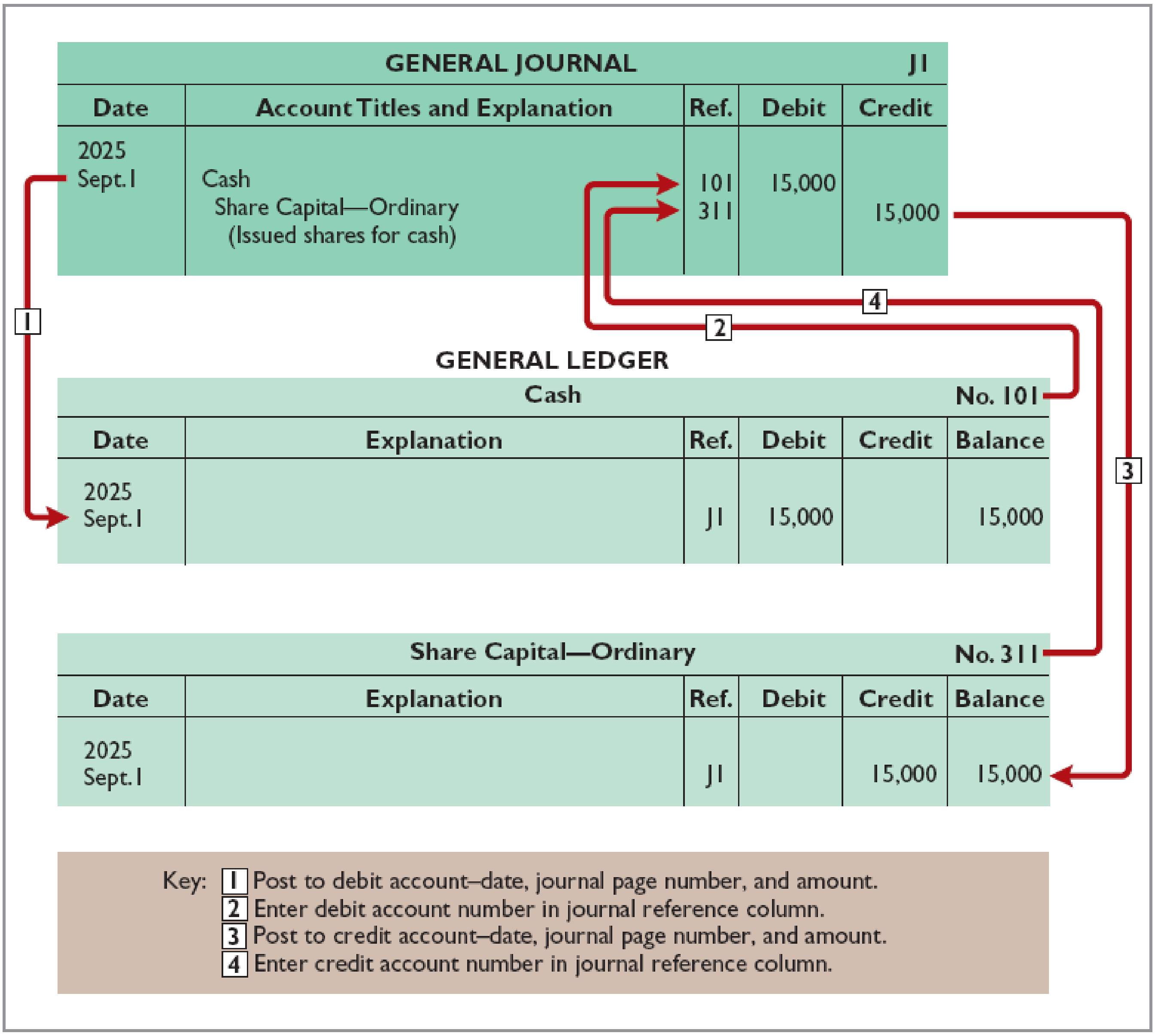
Posting

The procedure of transferring journal entries to the ledger accounts is called **posting**. This phase of the recording process accumulates the effects of journalized transactions into the individual accounts. Posting involves the following steps.

1. In the **ledger**, in the appropriate columns of the account(s) debited, enter the date, journal page, and debit amount shown in the journal.
2. In the reference column of the **journal**, write the account number to which the debit amount was posted.
3. In the **ledger**, in the appropriate columns of the account(s) credited, enter the date, journal page, and credit amount shown in the journal.
4. In the reference column of the **journal**, write the account number to which the credit amount was posted.

Illustration 2.18 shows these four steps using Softbyte SA's first journal entry. The boxed numbers indicate the sequence of the steps.

ILLUSTRATION 2.18 **Posting a journal entry**



Posting should be performed in chronological order. That is, the company should post all the debits and credits of one journal entry before proceeding to the next journal entry. Postings should be made on a timely basis to ensure that the ledger is up-to-date. *In homework problems, you can journalize all transactions before posting any of the journal entries.*

The reference column of a ledger account indicates the journal page from which the transaction was posted. (After the last entry has been posted, the accountant should scan the reference column **in the journal**, to confirm that all postings have been made.) The explanation space of the ledger account is used infrequently because an explanation already appears in the journal.

Chart of Accounts

The number and type of accounts differ for each company. The number of accounts depends on the amount of detail management desires. For example, the management of one company may want a single account for all types of utility expense. Another may keep separate expense accounts for each type of utility, such as gas, electricity, and water. Similarly, a small company like Softbyte SA will have fewer accounts than a giant company like **Hyundai** (KOR). Softbyte may be able to manage and report its activities in 20 to 30 accounts, while Hyundai may require thousands of accounts to keep track of its worldwide activities.

- Most companies have a chart of accounts. This chart lists the accounts and the account numbers that identify their location in the ledger.
- The numbering system that identifies the accounts usually starts with the statement of financial position accounts and follows with the income statement accounts.

In this and the next two chapters, we explain the accounting for Yazici Advertising A.Ş. (a service company). Accounts 101–199 indicate asset accounts; 200–299 indicate liabilities; 301–399 indicate equity accounts; 400–499, revenues;

601–799, expenses; 800–899, other revenues; and 900–999, other expenses. Illustration 2.19 shows Yazici's chart of accounts. Accounts listed in red are used in this chapter; accounts shown in black are explained in later chapters.

ILLUSTRATION 2.19 Chart of accounts

Yazici Advertising A.Ş.
Chart of Accounts

Assets	Equity
101 Cash	311 Share Capital—Ordinary
112 Accounts Receivable	320 Retained Earnings
126 Supplies	332 Dividends
130 Prepaid Insurance	350 Income Summary
157 Equipment	**Revenues**
158 Accumulated Depreciation—Equipment	400 Service Revenue
Liabilities	**Expenses**
200 Notes Payable	631 Supplies Expense
201 Accounts Payable	711 Depreciation Expense
209 Unearned Service Revenue	722 Insurance Expense
212 Salaries and Wages Payable	726 Salaries and Wages Expense
230 Interest Payable	729 Rent Expense
	732 Utilities Expense
	905 Interest Expense

You will notice that there are gaps in the numbering system of the chart of accounts for Yazici. Companies leave gaps to permit the insertion of new accounts as needed during the life of the business.

The Recording Process Illustrated

Illustrations 2.20 through 2.29 show the basic steps in the recording process, using the October transactions of Yazici Advertising A.Ş. Yazici's accounting period is a month. A basic analysis and a debit-credit analysis precede the journalizing and posting of each transaction. For simplicity, we use the T-account form in the illustrations instead of the standard account form. Study these transaction analyses carefully.

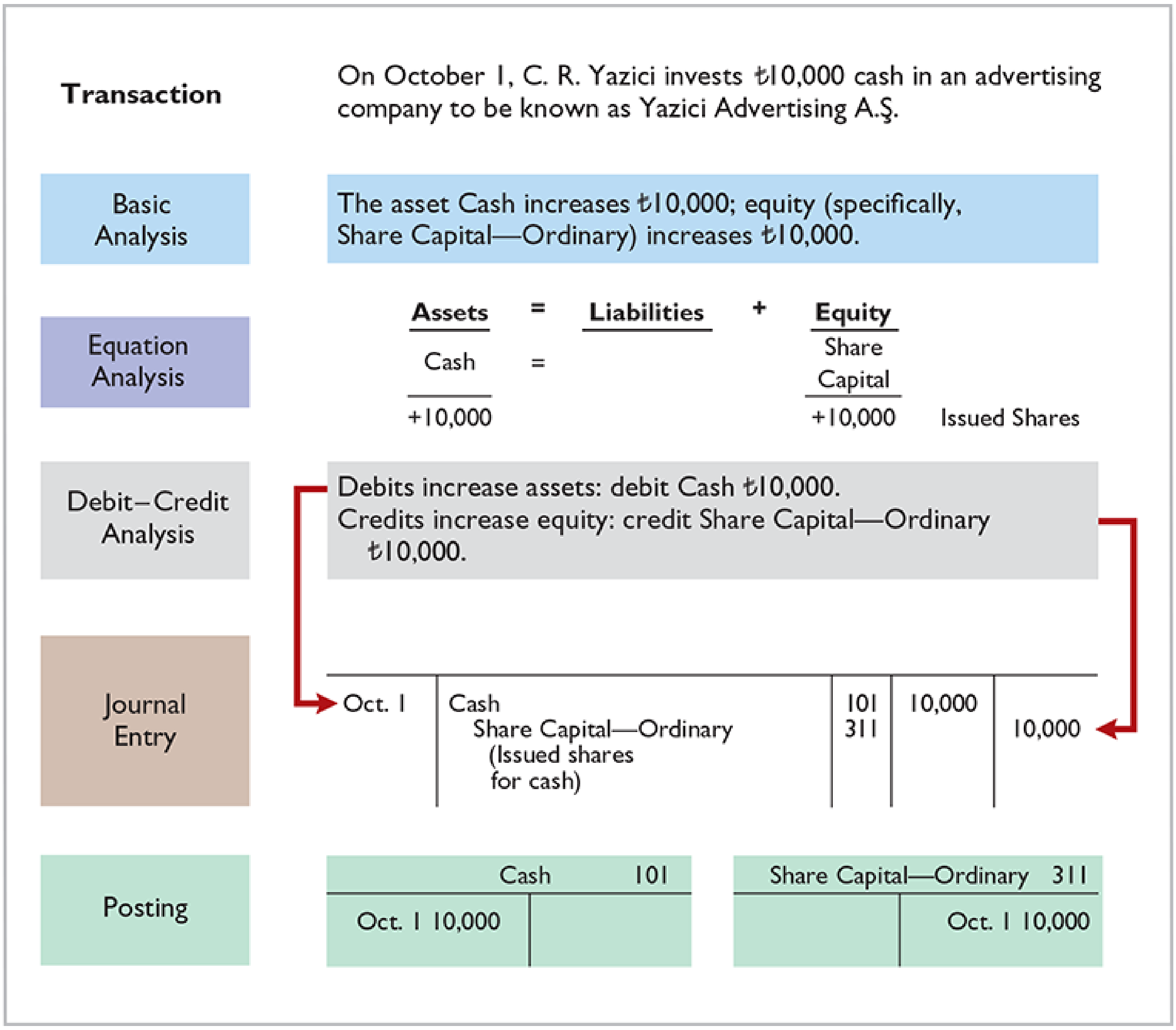
- **The purpose of transaction analysis is first to identify the type of account involved, and then to determine whether to make a debit or a credit to the account.**
- You should always perform this type of analysis before preparing a journal entry. Doing so will help you understand the journal entries discussed in this chapter as well as more complex journal entries in later chapters (see Helpful Hint).

HELPFUL HINT

Follow these steps:

1. **Determine what type of account is involved.**
2. **Determine what items increased or decreased and by how much.**
3. **Translate the increases and decreases into debits and credits.**

ILLUSTRATION 2.20 Investment of cash by shareholders



Cash flow analyses show the impact of each transaction on cash.

Cash Flows
+10,000

ILLUSTRATION 2.21 Purchase of office equipment

Transaction

On October 1, Yazici Advertising purchases office equipment costing ₺5,000 by signing a 3-month, 12%, ₺5,000 note payable.

Basic Analysis

The asset Equipment increases ₺5,000; the liability Notes Payable increases ₺5,000.

Equation Analysis

Assets	=	Liabilities	+	Equity
Equipment	=	Notes Payable		
+5,000		+5,000		

Debit–Credit Analysis

Debits increase assets: debit Equipment ₺5,000.
Credits increase liabilities: credit Notes Payable ₺5,000.

Journal Entry

Oct. 1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			

Posting

Equipment	157
Oct. 1 5,000	

Notes Payable	200
	Oct. 1 5,000

Cash Flows

no effect

ILLUSTRATION 2.22 **Receipt of cash for future service**

Many liabilities have the word "payable" in their title. But, note that Unearned Service Revenue is a liability even though the word *payable* is not used.

Transaction

On October 2, Yazici Advertising receives a ₺1,200 cash advance from R. Knox, a client, for advertising services that are expected to be completed by December 31.

Basic Analysis

The asset Cash increases ₺1,200; the liability Unearned Service Revenue increases ₺1,200 because the service has not been performed yet. That is, when Yazici receives an advance payment, it should record an unearned revenue (a liability) in order to recognize the obligation that exists. Note also that although many liabilities have the word "payable" in their title, unearned revenue is a liability because the obligation is satisfied by providing a product or performing a service.

Equation Analysis

Assets	=	**Liabilities**	+	**Equity**
Cash	=	Unearned Service Revenue		
+1,200		+1,200		

Debit–Credit Analysis

Debits increase assets: debit Cash ₺1,200.
Credits increase liabilities: credit Unearned Service Revenue ₺1,200.

Journal Entry

Oct. 2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future service)			

Posting

Cash		101
Oct. 1	10,000	
2	1,200	

Unearned Service Revenue		209
	Oct. 2	1,200

Cash Flows
+1,200

ILLUSTRATION 2.23 **Payment of monthly rent**

Transaction

On October 3, Yazici Advertising pays office rent for October in cash, ₺900.

Basic Analysis

Rent Expense increases ₺900 because the payment pertains only to the current month; the asset Cash decreases ₺900.

Equation Analysis

Assets	=	Liabilities	+	Equity	
Cash	=			Expenses	
−900				−900	Rent Expense

Debit–Credit Analysis

Debits increase expenses: debit Rent Expense ₺900.
Credits decrease assets: credit Cash ₺900.

Journal Entry

Oct. 3	Rent Expense	729	900	
	Cash	101		900
	(Paid October rent)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200		

Rent Expense			729
Oct. 3	900		

Cash Flows
−900

ILLUSTRATION 2.24 Payment for insurance

Transaction

On October 4, Yazici Advertising pays ₺600 for a one-year insurance policy that will expire next year on September 30.

Basic Analysis

The asset Prepaid Insurance increases ₺600 because the payment extends to more than the current month; the asset Cash decreases ₺600. Payments of expenses that will benefit more than one accounting period are prepaid expenses or prepayments. When a company makes a payment, it debits an asset account in order to show the service or benefit that will be received in the future.

Equation Analysis

Assets			=	Liabilities	+	Equity
Cash	+	Prepaid Insurance				
−600		+600				

Debit–Credit Analysis

Debits increase assets: debit Prepaid Insurance ₺600.
Credits decrease assets: credit Cash ₺600.

Journal Entry

Oct. 4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600

Prepaid Insurance			130
Oct. 4	600		

Cash Flows
−600

ILLUSTRATION 2.25 **Purchase of supplies on credit**

Transaction

On October 5, Yazici Advertising purchases an estimated 3-month supply of advertising materials on account from Aero Supply for ₺2,500.

Basic Analysis

The asset Supplies increases ₺2,500; the liability Accounts Payable increases ₺2,500.

Equation Analysis

Assets	=	Liabilities	+	Equity
Supplies	=	Accounts Payable		
+2,500		+2,500		

Debit–Credit Analysis

Debits increase assets: debit Supplies ₺2,500.
Credits increase liabilities: credit Accounts Payable ₺2,500.

Journal Entry

Oct. 5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			

Posting

Supplies	126
Oct. 5 2,500	

Accounts Payable	201
	Oct. 5 2,500

Cash Flows

no effect

ILLUSTRATION 2.26 **Hiring of employees**

Event

On October 9, Yazici Advertising hires four employees to begin work on October 15. Each employee is to receive a weekly salary of ₺500 for a 5-day work week, payable every 2 weeks—first payment made on October 26.

Basic Analysis

A business transaction has not occurred. There is only an agreement between the employer and the employees to enter into a business transaction beginning on October 15. Thus, a debit–credit analysis is not needed because there is no accounting entry. (See transaction of October 26 for first entry.)

Cash Flows

no effect

ILLUSTRATION 2.27 **Declaration and payment of dividend**

Transaction	On October 20, Yazici Advertising's board of directors declares and pays a ₺500 cash dividend to shareholders.
Basic Analysis	The Dividends account increases ₺500; the asset Cash decreases ₺500.
Equation Analysis	see below
Debit–Credit Analysis	Debits increase dividends: debit Dividends ₺500. Credits decrease assets: credit Cash ₺500.

Equation Analysis

Assets	=	Liabilities	+	Equity
Cash	=			Dividends
−500				−500

Journal Entry

Date	Account	Ref.	Debit	Credit
Oct. 20	Dividends	332	500	
	Cash	101		500
	(Declared and paid a cash dividend)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500

Dividends			332
Oct. 20	500		

Cash Flows
−500

ILLUSTRATION 2.28 **Payment of salaries**

Transaction

On October 26, Yazici Advertising owes employee salaries of ₺4,000 and pays them in cash. (See October 9 event.)

Basic Analysis

Salaries and Wages Expense increases ₺4,000; the asset Cash decreases ₺4,000.

Equation Analysis

Assets	=	Liabilities	+	Equity	
Cash	=			Expenses	
−4,000				−4,000	Salaries and Wages Expense

Debit–Credit Analysis

Debits increase expenses: debit Salaries and Wages Expense ₺4,000.
Credits decrease assets: credit Cash ₺4,000.

Journal Entry

Oct. 26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			

Posting

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
		20	500
		26	4,000

Salaries and Wages Expense			726
Oct. 26	4,000		

Cash Flows
−4,000

ILLUSTRATION 2.29 Receipt of cash for services provided

Transaction: On October 31, Yazici Advertising receives ₺10,000 in cash from Copa Company for advertising services performed in October.

Basic Analysis: The asset Cash increases ₺10,000; the revenue account Service Revenue increases ₺10,000.

Equation Analysis:

Assets	=	Liabilities	+	Equity	
Cash	=			Revenues	
+10,000				+10,000	Service Revenue

Debit–Credit Analysis: Debits increase assets: debit Cash ₺10,000.
Credits increase revenues: credit Service Revenue ₺10,000.

Journal Entry:

Oct. 31	Cash	101	10,000	
	Service Revenue	400		10,000
	(Received cash for services performed)			

Posting:

Cash			101
Oct. 1	10,000	Oct. 3	900
2	1,200	4	600
31	10,000	20	500
		26	4,000

Service Revenue			400
		Oct. 31	10,000

Cash Flows
+10,000

Summary Illustration of Journalizing and Posting

Illustration 2.30 shows the journal for Yazici Advertising A.Ş. for October.

ILLUSTRATION 2.30 General journal entries

GENERAL JOURNAL — PAGE J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
2025				
Oct. 1	Cash	101	10,000	
	Share Capital—Ordinary	311		10,000
	(Issued shares for cash)			
1	Equipment	157	5,000	
	Notes Payable	200		5,000
	(Issued 3-month, 12% note for office equipment)			
2	Cash	101	1,200	
	Unearned Service Revenue	209		1,200
	(Received cash from R. Knox for future services)			
3	Rent Expense	729	900	
	Cash	101		900
	(Paid October rent)			
4	Prepaid Insurance	130	600	
	Cash	101		600
	(Paid one-year policy; effective date October 1)			
5	Supplies	126	2,500	
	Accounts Payable	201		2,500
	(Purchased supplies on account from Aero Supply)			
20	Dividends	332	500	
	Cash	101		500
	(Declared and paid a cash dividend)			
26	Salaries and Wages Expense	726	4,000	
	Cash	101		4,000
	(Paid salaries to date)			
31	Cash	101	10,000	
	Service Revenue	400		10,000
	(Received cash for services performed)			

Illustration 2.31 shows the ledger, with all balances in red.

ILLUSTRATION 2.31 General ledger

GENERAL LEDGER

Cash **No. 101**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1	10,000		10,000
2		J1	1,200		11,200
3		J1		900	10,300
4		J1		600	9,700
20		J1		500	9,200
26		J1		4,000	5,200
31		J1	10,000		**15,200**

Supplies **No. 126**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 5		J1	2,500		**2,500**

Prepaid Insurance **No. 130**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 4		J1	600		**600**

Equipment **No. 157**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1	5,000		**5,000**

Notes Payable **No. 200**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1		5,000	**5,000**

Accounts Payable **No. 201**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 5		J1		2,500	**2,500**

Unearned Service Revenue **No. 209**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 2		J1		1,200	**1,200**

Share Capital—Ordinary **No. 311**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 1		J1		10,000	**10,000**

Dividends **No. 332**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 20		J1	500		**500**

Service Revenue **No. 400**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					

GENERAL LEDGER

Cash — **No. 101**

Oct. 31		J1		10,000	**10,000**

Salaries and Wages Expense — **No. 726**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 26		J1	4,000		**4,000**

Rent Expense — **No. 729**

Date	Explanation	Ref.	Debit	Credit	Balance
2025					
Oct. 3		J1	900		**900**

DO IT! 3

Posting

Como SpA recorded the following transactions in a general journal during the month of March

Mar. 4	Cash	2,280	
	Service Revenue		2,280
15	Salaries and Wages Expense	400	
	Cash		400
19	Utilities Expense	92	
	Cash		92

Post these entries to the Cash account of the general ledger to determine the ending balance in cash. The beginning balance in Cash on March 1 was €600.

ACTION PLAN

- **Recall that posting involves transferring the journalized debits and credits to specific accounts in the ledger.**
- **Determine the ending balance by netting the total debits and credits.**

Solution

Related exercise material: **BE2.7**, **BE2.8**, **DO IT! 2.3**, **E2.10**, **E2.11**, **E2.14**, **and** **E2.17**.

2.4 The Trial Balance

LEARNING OBJECTIVE 4

Prepare a trial balance.

A **trial balance** is a list of accounts and their balances at a given time.

- Companies usually prepare a trial balance at the end of an accounting period.
- They list accounts in the order in which they appear in the ledger.

- Debit balances appear in the left column and credit balances in the right column. The totals of the two columns must equal.

The trial balance proves the mathematical equality of debits and credits after posting. Under the double-entry system, this equality occurs when the sum of the debit account balances equals the sum of the credit account balances. **A trial balance may also uncover errors in journalizing and posting.** For example, a trial balance may well have detected the error at **Fidelity Investments** (USA) discussed in the Feature Story. **In addition, a trial balance is useful in the preparation of financial statements**, as we will explain in the next two chapters.

The steps for preparing a trial balance are:

1. List the account titles and their balances in the appropriate debit or credit column.
2. Total the debit and credit columns.
3. Verify the equality of the two columns.

Illustration 2.32 shows the trial balance prepared from Yazici Advertising A.Ş.'s ledger. Note that the total debits equal the total credits.

ILLUSTRATION 2.32 A trial balance

Yazici Advertising A.Ş.
Trial Balance
October 31, 2025

	Debit	Credit
Cash	₺15,200	
Supplies	2,500	
Prepaid Insurance	600	
Equipment	5,000	
Notes Payable		₺ 5,000
Accounts Payable		2,500
Unearned Service Revenue		1,200
Share Capital—Ordinary		10,000
Dividends	500	
Service Revenue		10,000
Salaries and Wages Expense	4,000	
Rent Expense	900	
	₺28,700	**₺28,700**

A trial balance is a necessary checkpoint for uncovering certain types of errors. For example, if only the debit portion of a journal entry has been posted, the trial balance would bring this error to light.

Limitations of a Trial Balance

A trial balance does not guarantee freedom from recording errors, however (see **Ethics Note**). Numerous errors may exist even though the totals of the trial balance columns agree. For example, the trial balance may balance even when:

1. A transaction is not journalized.
2. A correct journal entry is not posted.
3. A journal entry is posted twice.
4. Incorrect accounts are used in journalizing or posting.
5. Offsetting errors are made in recording the amount of a transaction.

ETHICS NOTE

An error is the result of an unintentional mistake; it is neither ethical nor unethical. An irregularity is an intentional misstatement, which is viewed as unethical.

As long as equal debits and credits are posted, even to the wrong account or in the wrong amount, the total debits will equal the total credits. **The trial balance does not prove that the company has recorded all transactions or that**

the ledger is correct.

Locating Errors

Errors in a trial balance generally result from mathematical mistakes, incorrect postings, or simply transcribing data incorrectly. What do you do if you are faced with a trial balance that does not balance? First, determine the amount of the difference between the two columns of the trial balance. After this amount is known, the following steps are often helpful.

1. If the error is €1, €10, €100, or €1,000, re-add the trial balance columns and recompute the account balances.
2. If the error is divisible by 2, scan the trial balance to see whether a balance equal to half the error has been entered in the wrong column.
3. If the error is divisible by 9, retrace the account balances on the trial balance to see whether they are incorrectly copied from the ledger. For example, if a balance was €12 and it was listed as €21, a €9 error has been made. Reversing the order of numbers is called a **transposition error**.
4. If the error is not divisible by 2 or 9, scan the ledger to see whether an account balance in the amount of the error has been omitted from the trial balance, and scan the journal to see whether a posting of that amount has been omitted.

Currency Signs and Underlining

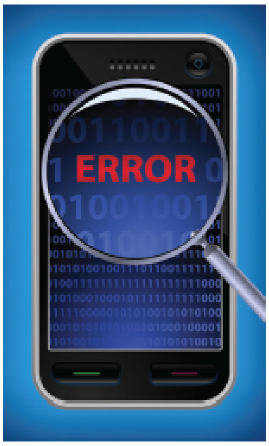
Note that currency signs do not appear in journals or ledgers. Currency signs are typically used only in the trial balance and the financial statements.

- Generally, a currency sign is shown only for the first item in the column and for the total of that column.
- A single line (a totaling rule) is placed under the column of figures to be added or subtracted.
- Total amounts are double-underlined to indicate they are final sums.

Investor Insight

Hypo Real Estate Holding

Why Accuracy Matters



jpa1999/Getty Images

The German Finance minister, Wolfgang Schäuble, said that “statistical and communication problems” were to blame for a €55.5 billion error in the accounts of nationalized property lender **Hypo Real Estate Holding** (DEU). He referred to the error as “an annoying mistake.”

This seems to be a considerable understatement considering that the error represented 2.6% of the German gross domestic product. Since the bank had been previously taken over by the German government, the error had resulted in an overstatement of the federal debt of €55.5 billion.

In order for this company to prepare and issue financial statements, its accounting equation (debits and credits) must have been in balance at year-end. How could this error have occurred?

Answer

DO IT! 4

Trial Balance

The following accounts come from the ledger of Bali Beach Supply at December 31, 2025.

157	Equipment	R$88,000	311	Share Capital—Ordinary	R$20,000
332	Dividends	8,000	212	Salaries and Wages	
201	Accounts Payable	22,000		Payable	2,000
726	Salaries and Wages		200	Notes Payable (due in 3 months)	19,000
	Expense	42,000	732	Utilities Expense	3,000
112	Accounts Receivable	4,000	130	Prepaid Insurance	6,000
400	Service Revenue	95,000	101	Cash	7,000

Prepare a trial balance in good form.

ACTION PLAN

- **Determine normal balances and list accounts in the order they appear in the ledger.**
- **Accounts with debit balances appear in the left column, and those with credit balances in the right column.**
- **Total the debit and credit columns to prove equality.**

Solution

Related exercise material: **BE2.9**, **BE2.10**, **DO IT! 2.4**, **E2.11**, **E2.12**, **E2.13**, **E2.15**, **E2.16**, **and E2.17**.

Review and Practice

Learning Objectives Review

1 Describe how accounts, debits, and credits are used to record business transactions.

An account is a record of increases and decreases in specific asset, liability, and equity items. The terms debit and credit are synonymous with left and right. Assets, dividends, and expenses are increased by debits and decreased by credits. Liabilities, share capital—ordinary, and revenues are increased by credits and decreased by debits.

2 Indicate how a journal is used in the recording process.

The basic steps in the recording process are (a) analyze each transaction for its effects on the accounts, (b) enter the transaction information in a journal, and (c) transfer the journal information to the appropriate accounts in the ledger.

The initial accounting record of a transaction is entered in a journal before the data are entered in the accounts. A journal (a) discloses in one place the complete effects of a transaction, (b) provides a chronological record of transactions, and (c) prevents or locates errors because the debit and credit amounts for each entry can be easily compared.

3 Explain how a ledger and posting help in the recording process.

The ledger is the entire group of accounts maintained by a company. The ledger provides the balance in each of the accounts as well as keeps track of changes in these balances. Posting is the transfer of journal entries to the ledger accounts. This phase of the recording process accumulates the effects of journalized transactions in the individual accounts.

4 Prepare a trial balance.

A trial balance is a list of accounts and their balances at a given time. Its primary purpose is to prove the equality of debits and credits after posting. A trial balance also uncovers errors in journalizing and posting and is useful in preparing financial statements.

Glossary Review

Account
A record of increases and decreases in specific asset, liability, or equity items.

Chart of accounts
A list of accounts and the account numbers that identify their location in the ledger.

Compound entry
A journal entry that involves three or more accounts.

Credit
The right side of an account.

Debit
The left side of an account.

Dividend
A distribution by a company to its shareholders.

Double-entry system
A system that records in appropriate accounts the dual effect of each transaction.

General journal
The most basic form of journal.

General ledger
A ledger that contains all asset, liability, and equity accounts.

Journal
An accounting record in which transactions are initially recorded in chronological order.

Journalizing
The entering of transaction data in the journal.

Ledger
The entire group of accounts maintained by a company.

Normal balance
An account balance on the side where an increase in the account is recorded.

Posting
The procedure of transferring journal entries to the ledger accounts.

Retained earnings
Net income that is kept (retained) in the business.

Simple entry
A journal entry that involves only two accounts.

T-account
The basic form of an account, consisting of (1) a title, (2) a left or debit side, and (3) a right or credit side.

Three-column form of account
A form with columns for debit, credit, and balance amounts in an account.

Trial balance
A list of accounts and their balances at a given time.

Practice Multiple-Choice Questions

1. (LO 1) Which of the following statements about an account is **true**?
   a. The right side of an account is the debit, or increase, side.
   b. An account is an individual accounting record of increases and decreases in specific asset, liability, and equity items.
   c. There are separate accounts for specific assets and liabilities but only one account for equity items.
   d. The left side of an account is the credit, or decrease, side.

Solution

2. (LO 1) Debits:

a. increase both assets and liabilities.

b. decrease both assets and liabilities.

c. increase assets and decrease liabilities.

d. decrease assets and increase liabilities.

Solution

3. (LO 1) A revenue account:

a. is increased by debits.

b. is decreased by credits.

c. has a normal balance of a debit.

d. is increased by credits.

Solution

4. (LO 1) Accounts that normally have debit balances are:

a. assets, expenses, and revenues.

b. assets, expenses, and share capital—ordinary.

c. assets, liabilities, and dividends.

d. assets, dividends, and expenses.

Solution

5. (LO 1) The expanded accounting equation is:

a. Assets + Liabilities = Share Capital + Retained Earnings + Dividends + Revenues + Expenses.

b. Assets = Liabilities + Share Capital + Retained Earnings + Dividends + Revenues – Expenses.

c. Assets = Liabilities – Share Capital – Retained Earnings – Dividends – Revenues – Expenses.

d. Assets = Liabilities + Share Capital + Retained Earnings + Revenues – Expenses – Dividends.

Solution

6. (LO 2) Which of the following is **not** part of the recording process?

a. Analyzing transactions.

b. Preparing an income statement.

c. Entering transactions in a journal.

d. Posting journal entries.

Solution

7. (LO 2) Which of the following statements about a journal is **false**?

a. It is not a book of original entry.

b. It provides a chronological record of transactions.

c. It helps to locate errors because the debit and credit amounts for each entry can be readily compared.

d. It discloses in one place the complete effect of a transaction.

Solution

8. (LO 2) The purchase of supplies on account should result in:

a. a debit to Supplies Expense and a credit to Cash.

b. a debit to Supplies Expense and a credit to Accounts Payable.

c. a debit to Supplies and a credit to Accounts Payable.

d. a debit to Supplies and a credit to Accounts Receivable.

Solution

9. (LO 3) The order of the accounts in the ledger is:

a. assets, revenues, expenses, liabilities, share capital—ordinary, dividends.

b. assets, liabilities, share capital—ordinary, dividends, revenues, expenses.

c. share capital—ordinary, assets, revenues, expenses, liabilities, dividends.

d. revenues, assets, expenses, liabilities, share capital—ordinary, dividends.

Solution

10. **(LO 3)** A ledger:

a. contains only asset and liability accounts.

b. should show accounts in alphabetical order.

c. is a collection of the entire group of accounts maintained by a company.

d. is a book of original entry.

Solution

11. **(LO 3)** Posting:

a. normally occurs before journalizing.

b. transfers ledger transaction data to the journal.

c. is an optional step in the recording process.

d. transfers journal entries to ledger accounts.

Solution

12. **(LO 3)** Before posting a payment of €5,000, the Accounts Payable of Green Grocers had a normal balance of €16,000. The balance after posting this transaction was:

a. €21,000.

b. €5,000.

c. €11,000.

d. cannot be determined.

Solution

13. **(LO 4)** A trial balance:

a. is a list of accounts with their balances at a given time.

b. proves the journalized transactions are correct.

c. will not balance if a correct journal entry is posted twice.

d. proves that all transactions have been recorded.

Solution

14. **(LO 4)** A trial balance will not balance if:

a. a correct journal entry is posted twice.

b. the purchase of supplies on account is debited to Supplies and credited to Cash.

c. a £100 dividend is debited to Dividends for £1,000 and credited to Cash for £100.

d. a £450 payment on account is debited to Accounts Payable for £45 and credited to Cash for £45.

Solution

15. **(LO 4)** The trial balance of Jeong Company had accounts with the following normal balances: Cash $5,000, Service Revenue $85,000, Salaries and Wages Payable $4,000, Salaries and Wages Expense $40,000, Rent Expense $10,000, Share Capital—Ordinary $42,000, Dividends $15,000, and Equipment $61,000. In preparing a trial balance, the total in the debit column is:

a. $131,000.

b. $216,000.

c. $91,000.

d. $116,000.

Solution

Practice Brief Exercises

Identify accounts to be debited and credited.

1. **(LO 1)** Transactions for Potter Designs for the month of May are presented below. Identify the accounts to be debited and credited for each transaction.

May	1	Shareholders invested £22,000 in the business.
	6	Paid office rent of £900.
	12	Performed consulting services and billed client £4,400.
	18	Purchased equipment on account for £1,200.

Solution

Journalize transactions.

2. **(LO 2)** Using the data from **Practice Brief Exercise 1**, journalize the transactions (omit explanations).

Solution

Post journal entries to T-accounts.

3. **(LO 3)** Selected transactions for Santana Outfitters are presented in journal form below. Post the transactions to T-accounts. Make one T-account for each account and determine each account's ending balance.

				J1
Date	**Account Titles and Explanation**	**Ref.**	**Debit**	**Credit**
June 6	Cash		22,000	
	Share Capital—Ordinary			22,000
	(Issued shares for cash)			
13	Accounts Receivable		8,200	
	Service Revenue			8,200
	(Billed for services performed)			
14	Cash		3,700	
	Accounts Receivable			3,700
	(Received cash in payment of account)			

Solution

Post journal entries to standard form of account.

4. **(LO 3)** Selected journal entries for Santana Outfitters are presented in **Practice Brief Exercise 3.** Post the transactions using the standard form of account.

Solution

Prepare a trial balance.

5. **(LO 4)** From the ledger accounts below, prepare a trial balance for Lee Investments at December 31, 2025. List the accounts in the order shown in the text. All account balances are normal (amounts in thousands).

Accounts Receivable	¥10,000	Salaries and Wages Expense	¥ 2,300
Supplies	4,100	Rent Expense	1,200
Accounts Payable	3,500	Share Capital—Ordinary	10,200
Dividends	1,100	Cash	6,000
Service Revenue	11,000		

Solution

Practice Exercises

Analyze and journalize transactions.

1. (LO 2) Presented below is information related to Provence Real Estate Agency (amounts in thousands).

Oct.	1	Henri Bos begins business as a real estate agent with a cash investment of €30,000 in exchange for ordinary shares.
	2	Paid rent, €700, on office space.
	3	Purchases office equipment for €2,800, on account.
	6	Sells a house and lot for Amit Das; bills Amit Das €4,400 for realty services performed.
	27	Pays €1,100 on the balance related to the transaction of October 3.
	30	Receives bill for October utilities, €130 (not paid at this time).

Instructions

Journalize the transactions. (You may omit explanations.)

Solution

Journalize transactions from account data and prepare a trial balance.

2. (LO 2, 4) The T-accounts below summarize the ledger of Depot Company at the end of the first month of operations (in U.S. dollars).

Cash			No. 101
4/1	16,000	4/15	700
4/12	1,200	4/25	1,600
4/29	900		
4/30	1,600		

Accounts Receivable			No. 112
4/7	2,900	4/29	900

Supplies			No. 126
4/4	1,900		

Accounts Payable			No. 201
4/25	1,600	4/4	1,900

Unearned Service Revenue			No. 209
		4/30	1,600

Share Capital—Ordinary			No. 311
		4/1	16,000

Service Revenue			No. 400
		4/7	2,900
		4/12	1,200

Salaries and Wages Expense			No. 726
4/15	700		

Instructions

a. Prepare the complete general journal (including explanations).

b. Prepare a trial balance at April 30, 2025.

Solution

Practice Problem

Journalize transactions, post, and prepare a trial balance.

(LO 1, 2, 3, 4) A group of student-investors in Hong Kong opened Campus Laundromat Ltd. on September 1, 2025. During the first month of operations, the following transactions occurred.

Sept.	1	Shareholders invested HK$20,000 cash in the business in exchange for ordinary shares.
	2	The company paid HK$1,000 cash for store rent for September.
	3	Purchased washers and dryers for HK$25,000, paying HK$10,000 in cash and signing a HK$15,000, 6-month, 12% note payable.
	4	Paid HK$1,200 for a one-year accident insurance policy.
	10	Received a bill from the *Daily News* for online advertising of the opening of the laundromat HK$200.
	20	Declared and paid a cash dividend to shareholders of HK$700.
	30	The company determined that cash receipts for laundry services for the month were HK$6,200.

The chart of accounts for the company is the same as that for Yazici Advertising A.Ş. in Illustration 2.19 plus No. 610 Advertising Expense.

Instructions

a. Journalize the September transactions. (Use J1 for the journal page number.)

b. Open ledger accounts and post the September transactions.

c. Prepare a trial balance at September 30, 2025.

Solution

Questions

1. Describe the parts of a T-account.

2. "The terms debit and credit mean increase and decrease, respectively." Do you agree? Explain.

3. Pete Harcourt, a fellow student, contends that the double-entry system means each transaction must be recorded twice. Is Pete correct? Explain.

4. Melissa Estes, a beginning accounting student, believes debit balances are favorable and credit balances are unfavorable. Is Melissa correct? Discuss.

5. State the rules of debit and credit as applied to (a) asset accounts, (b) liability accounts, and (c) the equity accounts (revenue, expenses, dividends, and share capital—ordinary).

6. What is the normal balance for each of the following accounts? (a) Accounts Receivable. (b) Cash. (c) Dividends. (d) Accounts Payable. (e) Service Revenue. (f) Salaries and Wages Expense. (g) Share Capital—Ordinary.

7. Indicate whether each of the following accounts is an asset, a liability, or an equity account and whether it has a normal debit or credit balance: (a) Accounts Receivable, (b) Accounts Payable, (c) Equipment, (d) Dividends, and (e) Supplies.

8. For the following transactions, indicate the account debited and the account credited.

a. Supplies are purchased on account.

b. Cash is received on signing a note payable.

c. Employees are paid salaries in cash.

9. Indicate whether the following accounts generally will have (a) debit entries only, (b) credit entries only, or (c) both debit and credit entries.

1. Cash.
2. Accounts Receivable.
3. Dividends.
4. Accounts Payable.
5. Salaries and Wages Expense.
6. Service Revenue.

10. What are the basic steps in the recording process?

11. What are the advantages of using a journal in the recording process?

12.

a. When entering a transaction in the journal, should the debit or credit be written first?

b. Which should be indented, the debit or credit?

13. Describe a compound entry, and provide an example.

14.

a. Should business transaction debits and credits be recorded directly in the ledger accounts?

b. What are the advantages of first recording transactions in the journal and then posting to the ledger?

15. The account number is entered as the last step in posting the amounts from the journal to the ledger. What is the advantage of this step?

16. Journalize the following business transactions.

a. Alberto Rivera invests €7,000 cash in the business in exchange for ordinary shares.

b. Insurance of €800 is paid for the year.

c. Supplies of €2,000 are purchased on account.

d. Cash of €8,500 is received for services performed.

17.

a. What is a ledger?

b. What is a chart of accounts and why is it important?

18. What is a trial balance and what are its purposes?

19. Victor Grimm is confused about how accounting information flows through the accounting system. He believes the flow of information is as follows.

a. Debits and credits posted to the ledger.

b. Business transaction occurs.

c. Information entered in the journal.

d. Financial statements are prepared.

e. Trial balance is prepared.

Is Victor correct? If not, indicate to Victor the proper flow of the information.

20. Two students are discussing the use of a trial balance. They wonder whether the following errors, each considered separately, would prevent the trial balance from balancing.

a. The bookkeeper debited Cash for €600 and credited Salaries and Wages Expense for €600 for payment of wages.

b. Cash collected on account was debited to Cash for €800 and Service Revenue was credited for €80.

What would you tell them?

21. What are the normal balances for **TSMC**'s Cash, Accounts Payable, and Interest Expense accounts?

Brief Exercises

Indicate debit and credit effects and normal balance.

BE2.1 **(LO 1)** For each of the following accounts, indicate the effects of (a) a debit and (b) a credit on the accounts and (c) the normal balance of the account.

1. Accounts Payable.
2. Advertising Expense.
3. Service Revenue.
4. Accounts Receivable.
5. Share Capital—Ordinary.
6. Dividends.

Identify accounts to be debited and credited.

BE2.2 **(LO 1)** Transactions for Thorn Consulting for the month of June are presented below. Identify the accounts to be debited and credited for each transaction.

June 1 Oleg Thorn invests €5,000 cash in a small welding business in exchange for ordinary shares.

2	Purchases equipment on account for €3,600.
3	€800 cash is paid to landlord for June rent.
12	Sends a bill to K. Johnsen for €400 after completing welding work done on account.

Journalize transactions.

BE2.3 (LO 2) Using the data in BE2.2, journalize the transactions. (You may omit explanations.)

Identify and explain steps in recording process.

BE2.4 (LO 2) **Writing** Shea Jonas, a fellow student, is unclear about the basic steps in the recording process. Identify and briefly explain the steps in the order in which they occur.

Indicate basic and debit-credit analysis.

BE2.5 (LO 1) Gonzales SA, a financial advising company, has the following transactions during August of the current year, its first month of operations. Indicate (a) the effect on the accounting equation and (b) the debit-credit analysis as illustrated in the text.

Aug.	1	Shareholders invest R$9,000 in cash in exchange for ordinary shares.
	4	Pays insurance in advance for 6 months, R$2,100 cash.
	16	Receives R$3,600 from clients for services performed.
	27	Pays secretary R$1,000 salary.

Journalize transactions.

BE2.6 (LO 2) Using the data in BE2.5, journalize the transactions. (You may omit explanations.)

Post journal entries to T-accounts.

BE2.7 (LO 3) Selected transactions for Wang Enterprises are presented in journal form below. Post the transactions to T-accounts. Make one T-account for each account and determine each account's ending balance.

J1

Date	Account Titles and Explanation	Ref.	Debit	Credit
May 5	Accounts Receivable		5,400	
	Service Revenue			5,400
	(Billed for services performed)			
12	Cash		4,200	
	Accounts Receivable			4,200
	(Received cash in payment of account)			
15	Cash		3,000	
	Service Revenue			3,000
	(Received cash for services performed)			

Post journal entries to standard form of account.

BE2.8 (LO 3) Selected journal entries for Wang Enterprises are presented in BE2.7. Post the transactions using the standard form of account.

Prepare a trial balance.

BE2.9 (LO 4) From the ledger balances given below, prepare a trial balance for Amaro Company at June 30, 2025. List the accounts in the order shown in the text. All account balances are normal.

Accounts Payable $8,100, Cash $5,800, Share Capital—Ordinary $15,000, Dividends $1,200, Equipment $17,000, Service Revenue $10,000, Accounts Receivable $3,000, Salaries and Wages Expense $5,100, and Rent Expense $1,000.

Prepare a correct trial balance.

BE2.10 (LO 4) An inexperienced bookkeeper prepared the following trial balance. Prepare a correct trial balance, assuming all account balances are normal.

Chang Ltd.
Trial Balance
December 31, 2025

	Debit	Credit
Cash	£10,600	
Prepaid Insurance		£ 3,500
Accounts Payable		3,000
Unearned Service Revenue	2,200	
Share Capital—Ordinary		9,000
Dividends		4,500
Service Revenue		25,400
Salaries and Wages Expense	18,600	
Rent Expense		2,400
	£31,400	£47,800

DO IT! Exercises

Identify normal balances.

DO IT! 2.1 (LO 1) Tom Rast has just rented space in a strip mall. In this space, he will open a photography studio, to be called "Picture This!" A friend has advised Tom to set up a double-entry set of accounting records in which to record all of his business transactions.

Identify the statement of financial position accounts that Tom will likely need to record the transactions needed to open his business (a corporation). Indicate whether the normal balance of each account is a debit or credit.

Record business activities.

DO IT! 2.2 (LO 2) Tom Rast engaged in the following activities in establishing his photography studio, Picture This!:

1. Opened a bank account in the name of Picture This! and deposited £6,500 of his own money into this account in exchange for ordinary shares.
2. Purchased photography supplies at a total cost of £1,200. The business paid £400 in cash and the balance is on account.
3. Obtained estimates on the cost of photography equipment from three different manufacturers.

Prepare the journal entries to record the transactions. (You may omit explanations.)

Post transactions.

DO IT! 2.3 (LO 3) Tom Rast recorded the following transactions during the month of April.

April 3	Cash	3,400	
	Service Revenue		3,400
April 16	Rent Expense	700	
	Cash		700
April 20	Salaries and Wages Expense	250	
	Cash		250

Post these entries to the Cash T-account of the general ledger to determine the ending balance in cash. The beginning balance in cash on April 1 was £1,600.

Prepare a trial balance.

DO IT! 2.4 (LO 4) The following accounts are taken from the ledger of Chillin' Company at December 31, 2025.

200	Notes Payable	R$20,000	101	Cash	R$ 6,000
311	Share Capital—Ordinary	28,000	126	Supplies	7,000
157	Equipment	80,000	729	Rent Expense	4,000
332	Dividends	9,000	212	Salaries and Wages Payable	3,000
726	Salaries and Wages Expense	38,000	201	Accounts Payable	11,000
400	Service Revenue	90,000	112	Accounts Receivable	8,000

Prepare a trial balance in good form.

Exercises

Analyze statements about accounting and the recording process.

E2.1 (LO 1) Kim Yi has prepared the following list of statements about accounts.

1. An account is an accounting record of either a specific asset or a specific liability.
2. An account shows only increases, not decreases, in the item it relates to.
3. Some items, such as Cash and Accounts Receivable, are combined into one account.
4. An account has a left, or credit side, and a right, or debit side.
5. A simple form of an account consisting of just the account title, the left side, and the right side, is called a T-account.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Identify debits, credits, and normal balances.

E2.2 (LO 1) Selected transactions for Acosta Decor, an interior design company, in its first month of business are as follows.

Jan.	2	Marie Acosta invested €10,000 cash in business in exchange for ordinary shares.
	3	Purchased a used car for €3,000 cash for use in business.
	9	Purchased supplies on account for €600.
	11	Billed customers €2,400 for services performed.
	16	Paid €350 cash for advertising.
	20	Received €900 cash from customers billed on January 11.
	23	Paid creditor €300 cash on balance owed.
	28	Declared and paid a €1,000 cash dividend.

Instructions

For each transaction, indicate the following.

a. The basic type of account debited and credited (asset, liability, equity).

b. The specific account debited and credited (Cash, Rent Expense, Service Revenue, etc.).

c. Whether the specific account is increased or decreased.

d. The normal balance of the specific account.

Use the following format, in which the January 2 transaction is given as an example.

	Account Debited				Account Credited			
Date	**(a) Basic Type**	**(b) Specific Account**	**(c) Effect**	**(d) Normal Balance**	**(a) Basic Type**	**(b) Specific Account**	**(c) Effect**	**(d) Normal Balance**
Jan. 2	Asset	Cash	Increase	Debit	Equity	Share Capital—Ordinary	Increase	Credit

Journalize transactions.

E2.3 (LO 2) Data for Acosta Decor are presented in E2.2.

Instructions

Journalize the transactions using journal page J1. (You may omit explanations.)

Analyze transactions and determine their effect on accounts.

E2.4 (LO 3) The following information relates to Yansheng Real Estate.

Oct.	1	Biao Yansheng begins business as a real estate agent with a cash investment of HK$17,000 in exchange for ordinary shares.
	2	Hires a part-time administrative assistant.
	3	Purchases supplies for HK$1,900, on account.
	6	Sells a house and lot for C. Chow; bills C. Chow HK$3,800 for realty services performed.
	27	Pays HK$1,300 on the balance related to the transaction of October 3.
	30	Pays the administrative assistant HK$2,500 in salary for October.

Instructions

Prepare the debit-credit analysis for each transaction as illustrated in the text.

Journalize transactions.

E2.5 (LO 2) Transaction data for Yansheng Real Estate are presented in E2.4.

Instructions

Journalize the transactions. (You may omit explanations.)

Analyze transactions and journalize.

E2.6 (LO 1, 2) Lennon Industries had the following transactions.

1. Borrowed €5,000 from the bank by signing a note.
2. Paid €3,900 cash for a computer.
3. Purchased €650 of supplies on account.

Instructions

a. Indicate what accounts are increased and decreased by each transaction.
b. Journalize each transaction. (Omit explanations.)

Analyze transactions and journalize.

E2.7 (LO 1, 2) Ong Enterprises had the following selected transactions.

1. Shareholders invested NT$40,000 cash in the business in exchange for ordinary shares.
2. Paid office rent of NT$8,400.
3. Performed consulting services and billed a client NT$52,000.
4. Declared and paid a NT$7,500 dividend.

Instructions

a. Indicate the effect each transaction has on the accounting equation (Assets = Liabilities + Equity), using plus and minus signs.
b. Journalize each transaction. (Omit explanations.)

Journalize a series of transactions.

E2.8 (LO 2) Selected transactions for Sophie's Dog Care are as follows during the month of March.

March	1	Paid monthly rent of $1,200.
	3	Performed services for $160 on account.
	5	Performed services for cash of $75.
	8	Purchased equipment for $600. The company paid cash of $90 and the balance was on account.
	12	Received cash from customers billed on March 3.
	14	Paid salaries and wages to employees of $525.
	22	Paid utilities of $72.
	24	Borrowed $1,500 from Grafton State Bank by signing a note.
	27	Paid $220 to repair service for plumbing repairs.
	28	Paid balance amount owed from equipment purchase on March 8.

30 Paid $1,800 for six months of insurance.

Instructions

Journalize the transactions. (Omit explanations.)

Record journal entries.

E2.9 (LO 2) On April 1, Adventures Travel Agency began operations. The following transactions were completed during the month.

1. Shareholders invested $24,000 in the business in exchange for ordinary shares.
2. Obtained a bank loan for $7,000 by issuing a note payable.
3. Paid $11,000 cash to buy equipment.
4. Paid $1,200 cash for April office rent.
5. Paid $1,450 for supplies.
6. Purchased $600 of advertising in the *Daily Herald,* on account.
7. Performed services for $18,000: cash of $2,000 was received from customers, and the balance of $16,000 was billed to customers on account.
8. Declared and paid a cash dividend of $400.
9. Paid the utility bill for the month, $2,000.
10. Paid *Daily Herald* the amount due in transaction (6).
11. Paid $40 of interest on the bank loan obtained in transaction (2).
12. Paid employees' salaries and wages, $6,400.
13. Received $12,000 cash from customers billed in transaction (7).

Instructions

Journalize the transactions. (Omit explanations).

Analyze statements about the ledger.

E2.10 (LO 3) Alma Ortiz has prepared the following list of statements about the general ledger.

1. The general ledger contains all the asset and liability accounts but no equity accounts.
2. The general ledger is sometimes referred to as simply the ledger.
3. The accounts in the general ledger are arranged in alphabetical order.
4. Each account in the general ledger is numbered for easier identification.
5. The general ledger is a book of original entry.

Instructions

Identify each statement as true or false. If false, indicate how to correct the statement.

Post journal entries and prepare a trial balance.

E2.11 (LO 3, 4) Selected transactions from the journal of Wong Consultants are presented below (amounts in ¥ thousands).

Date	Account Titles and Explanation	Ref.	Debit	Credit
Aug. 1	Cash		5,000	
	Share Capital—Ordinary			5,000
	(Issued shares for cash)			
10	Cash		2,600	
	Service Revenue			2,600
	(Received cash for services performed)			
12	Equipment		5,000	
	Cash			2,300
	Notes Payable			2,700
	(Purchased equipment for cash and notes payable)			
25	Accounts Receivable		1,700	
	Service Revenue			1,700
	(Billed clients for services performed)			
31	Cash		900	
	Accounts Receivable			900
	(Receipt of cash on account)			

Instructions

a. Post the transactions to T-accounts.

b. Prepare a trial balance at August 31, 2025.

Journalize transactions from account data and prepare a trial balance.

E2.12 (LO 2, 4) The T-accounts below summarize the ledger of Negrete Landscaping at the end of the first month of operations (amounts in €).

Cash — No. 101

4/1	14,000	4/15	1,300
4/12	900	4/25	1,500
4/29	400		
4/30	1,000		

Unearned Service Revenue — No. 209

		4/30	1,000

Accounts Receivable — No. 112

4/7	3,000	4/29	400

Share Capital—Ordinary — No. 311

		4/1	14,000

Supplies — No. 126

4/4	1,800		

Service Revenue — No. 400

		4/7	3,000
		4/12	900

Accounts Payable — No. 201

4/25	1,500	4/4	1,800

Salaries and Wages Expense — No. 726

4/15	1,300		

Instructions

a. Prepare the complete general journal (including explanations) from which the postings were made.

b. Prepare a trial balance at April 30, 2025.

Journalize transactions from account data and prepare a trial balance.

E2.13 (LO 2, 4) Presented below is the ledger for Shumway Co. (amounts in thousands of ¥).

Cash No. 101

10/1	3,000	10/4	400
10/10	750	10/12	1,500
10/10	4,000	10/15	350
10/20	500	10/30	300
10/25	2,000	10/31	500

Share Capital—Ordinary No. 311

		10/1	3,000
		10/25	2,000

Dividends No. 332

10/30	300		

Accounts Receivable No. 112

10/6	800	10/20	500
10/20	940		

Service Revenue No. 400

		10/6	800
		10/10	750
		10/20	940

Supplies No. 126

10/4	400		

Salaries and Wages Expense No. 726

10/31	500		

Equipment No. 157

10/3	2,000		

Rent Expense No. 729

10/15	350		

Notes Payable No. 200

		10/10	4,000

Accounts Payable No. 201

10/12	1,500	10/3	2,000

Instructions

a. Reproduce the journal entries for the transactions that occurred on October 1, 10, and 20, and provide explanations for each.

b. Determine the October 31 balance for each of the accounts above, and prepare a trial balance at October 31, 2025.

Prepare journal entries and post using standard account form.

E2.14 (LO 2, 3) Selected transactions for Ling Couture during its first month in business are presented below.

Sept.	1	Shareholders invested NT$10,000 cash in the business in exchange for ordinary shares.
	5	Purchased equipment for NT$14,000 paying NT$4,000 in cash and the balance on account.
	25	Paid NT$3,000 cash on balance owed for equipment.
	30	Declared and paid a NT$900 dividend.

Ling's chart of accounts shows No. 101 Cash, No. 157 Equipment, No. 201 Accounts Payable, No. 311 Share Capital—Ordinary, and No. 332 Dividends.

Instructions

a. Journalize the transactions on page J1 of the journal. (Omit explanations.)

b. Post the transactions using the standard account form.

Analyze errors and their effects on trial balance.

E2.15 (LO 4) The bookkeeper for Kang Equipment Repair made a number of errors in journalizing and posting, as described below.

1. A credit posting of $525 to Accounts Receivable was omitted.
2. A debit posting of $750 for Prepaid Insurance was debited to Insurance Expense.
3. A collection from a customer of $100 in payment of its account owed was journalized and posted as a debit to Cash $100 and a credit to Service Revenue $100.
4. A credit posting of $415 to Property Taxes Payable was made twice.

5. A cash purchase of supplies for $250 was journalized and posted as a debit to Supplies $25 and a credit to Cash $25.
6. A debit of $625 to Advertising Expense was posted as $652.

Instructions

For each error:

a. Indicate whether the trial balance will balance.
b. If the trial balance will not balance, indicate the amount of the difference.
c. Indicate the trial balance column that will have the larger total.

Consider each error separately. Use the following form, in which error (1) is given as an example.

Error	(a) In Balance	(b) Difference	(c) Larger Column
(1)	No	$525	debit

Prepare a trial balance.

E2.16 (LO 4) The accounts in the ledger of Overnite Delivery Service contain the following balances on July 31, 2025 (amounts in thousands).

Accounts Receivable	¥ 7,640	Prepaid Insurance	¥ 1,968
Accounts Payable	8,394	Maintenance and Repairs Expense	961
Cash	?	Service Revenue	10,610
Equipment	45,360	Dividends	700
Gasoline Expense	758	Share Capital—Ordinary	38,000
Utilities Expense	523	Salaries and Wages Expense	4,428
Notes Payable	17,000	Salaries and Wages Payable	815

Instructions

Prepare a trial balance with the accounts arranged as illustrated in the chapter and fill in the missing amount for Cash.

Journalize transactions, post transactions to T-accounts, and prepare trial balance.

E2.17 (LO 2, 3, 4) Beyers Security provides security services. Selected transactions for Beyers are presented below.

Oct.	1	Received $66,000 cash in the business in exchange for ordinary shares.
	2	Hired part-time security consultant. Salary will be $2,000 per month. First day of work will be October 15.
	4	Paid one month of rent for building for $2,000.
	7	Purchased equipment for $18,000, paying $4,000 cash and the balance on account.
	8	Paid $500 for advertising.
	10	Received bill for equipment repair cost of $390.
	12	Provided security services for event for $3,200 on account.
	16	Purchased supplies for $410 on account.
	21	Paid balance due from October 7 purchase of equipment.
	24	Received and paid utility bill for $148.
	27	Received payment from customer for October 12 services performed.
	31	Paid employee salaries and wages of $5,100.

Instructions

a. Journalize the transactions. Do not provide explanations.
b. Post the transactions to T-accounts.
c. Prepare a trial balance at October 31, 2025. (*Hint:* Compute ending balances of T-accounts first.)

Problems

Journalize a series of transactions.

P2.1 (LO 1, 2) Feng Disc Golf Course was opened on March 1. The following selected events and transactions occurred during March (amounts in thousands).

Mar.	1	Lee Feng invested ¥20,000 cash in the business in exchange for ordinary shares.
	3	Purchased Rainbow Golf Land for ¥15,000 cash. The price consists of land ¥12,000, building ¥2,000, and equipment ¥1,000. (Make one compound entry.)
	5	Paid advertising expenses of ¥900.
	6	Paid cash ¥600 for a one-year insurance policy.
	10	Purchased golf discs and other equipment for ¥1,050 from Wang Company payable in 30 days.
	18	Received ¥1,100 in cash for golf fees (Feng records golf fees as service revenue).
	19	Sold 150 coupon books for ¥10 each. Each book contains 4 coupons that enable the holder to play one round of disc golf.
	25	Declared and paid a ¥800 cash dividend.
	30	Paid salaries of ¥250.
	30	Paid Wang Company in full.
	31	Received ¥2,700 cash for golf fees.

Feng Disc Golf uses the following accounts: Cash, Prepaid Insurance, Land, Buildings, Equipment, Accounts Payable, Unearned Service Revenue, Share Capital—Ordinary, Dividends, Service Revenue, Advertising Expense, and Salaries and Wages Expense.

Instructions

Journalize the March transactions.

Journalize transactions, post, and prepare a trial balance.

P2.2 (LO 1, 2, 3, 4) Emily Stansbury is a licensed dentist. During the first month of the operation of her business, the following events and transactions occurred.

April	1	Invested €20,000 cash in her business in exchange for ordinary shares.
	1	Hired a secretary-receptionist at a salary of €700 per week payable monthly.
	2	Paid office rent for the month €1,100.
	3	Purchased dental supplies on account from Dazzle Company €4,000.
	10	Performed dental services and billed insurance companies €5,100.
	11	Received €1,000 cash advance from Leah Mataruka for an implant.
	20	Received €2,100 cash for services performed from Michael Santos.
	30	Paid secretary-receptionist for the month €2,800.
	30	Paid €2,400 to Dazzle for accounts payable due.

Emily uses the following chart of accounts: No. 101 Cash, No. 112 Accounts Receivable, No. 126 Supplies, No. 201 Accounts Payable, No. 209 Unearned Service Revenue, No. 311 Share Capital—Ordinary, No. 400 Service Revenue, No. 726 Salaries and Wages Expense, and No. 729 Rent Expense.

Instructions

a. Journalize the transactions.

b. Post to the ledger accounts.

c. Prepare a trial balance on April 30, 2025.

c. Trial balance totals €29,800

Journalize transactions, post, and prepare a trial balance.

P2.3 (LO 1, 2, 3, 4) Kochi Services was formed on May 1, 2025. The following transactions took place during the first month (amounts in thousands).

Transactions on May 1:

1. Rahul Shah invested ₹40,000 cash in the company in exchange for ordinary shares.
2. Hired two employees to work in the warehouse. They will each be paid a salary of ₹3,050 per month.
3. Signed a 2-year rental agreement on a warehouse; paid ₹24,000 cash in advance for the first year.
4. Purchased furniture and equipment costing ₹30,000. A cash payment of ₹10,000 was made immediately; the remainder will be paid in 6 months.
5. Paid ₹1,800 cash for a one-year insurance policy on the furniture and equipment.

Transactions during the remainder of the month:

6. Purchased basic office supplies for ₹420 cash.
7. Purchased more office supplies for ₹1,500 on account.
8. Total revenues earned were ₹20,000–₹8,000 cash and ₹12,000 on account.
9. Paid ₹400 to suppliers for accounts payable due.
10. Received ₹3,000 from customers in payment of accounts receivable.
11. Received utility bills in the amount of ₹380, to be paid next month.
12. Paid the monthly salaries of the two employees, totaling ₹6,100.

Instructions

a. Prepare journal entries to record each of the events listed. (Omit explanations.)

b. Post the journal entries to T-accounts.

c. Prepare a trial balance as of May 31, 2025.

c. Trial balance totals ₹81,480

Prepare a correct trial balance.

P2.4 (LO 4) The trial balance of De Bortoli Co. shown below does not balance.

De Bortoli Co.
Trial Balance
June 30, 2025

	Debit	Credit
Cash		$ 3,340
Accounts Receivable	$ 2,812	
Supplies	1,200	
Equipment	2,600	
Accounts Payable		3,666
Unearned Service Revenue	1,100	
Share Capital—Ordinary		8,000
Dividends	800	
Service Revenue		2,480
Salaries and Wages Expense	3,200	
Utilities Expense	810	
	$12,522	$17,486

Each of the listed accounts has a normal balance per the general ledger. An examination of the ledger and journal reveals the following errors.

1. Cash received from a customer in payment of its account was debited for $580, and Accounts Receivable was credited for the same amount. The actual collection was for $850.
2. The purchase of a computer on account for $710 was recorded as a debit to Supplies for $710 and a credit to Accounts Payable for $710.
3. Services were performed on account for a client for $980. Accounts Receivable was debited for $980, and Service Revenue was credited for $98.
4. A debit posting to Salaries and Wages Expense of $700 was omitted.
5. A payment of a balance due for $306 was credited to Cash for $306 and credited to Accounts Payable for $360.
6. A dividend of $600 cash was debited to Salaries and Wages Expense for $600 and credited to Cash for $600.

Instructions

Prepare a correct trial balance. (*Hint:* It helps to prepare the correct journal entry for the transaction described and compare it to the mistake made.)

Trial balance totals $15,462

Journalize transactions, post, and prepare a trial balance.

P2.5 (LO 1, 2, 3, 4) The Sun Theater will begin operations in March. The Sun will be unique in that it will show only triple features of sequential theme movies. As of March 1, the ledger of Sun showed No. 101 Cash ₩3,000, No. 140 Land ₩24,000, No. 145 Buildings (concession stand, projection room, ticket booth, and screen) ₩10,000, No. 157 Equipment ₩10,000, No. 201 Accounts Payable ₩7,000, and No. 311 Share Capital—Ordinary ₩40,000. During the month of March, the following events and transactions occurred (amounts in thousands).

Mar.	2	Rented the three *Kung Fu Panda* movies to be shown for the first 3 weeks of March. The film rental was ₩3,500; ₩1,500 was paid in cash and ₩2,000 will be paid on March 10.
	3	Ordered three *Batman* movies to be shown the last 10 days of March. It will cost ₩200 per night.
	9	Received ₩4,300 cash from admissions.
	10	Paid balance due on *Kung Fu Panda* movies rental and ₩2,100 on March 1 accounts payable.
	11	Sun Theater contracted with So Bin to operate the concession stand. Bin is to pay 15% of gross concession receipts, payable monthly, for the rental of the concession stand.
	12	Paid advertising expenses ₩900.
	20	Received ₩5,000 cash from customers for admissions.
	20	Received the *Batman* movies and paid the rental fee of ₩2,000.
	31	Paid salaries of ₩3,100.
	31	Received statement from So Bin showing gross receipts from concessions of ₩6,000 and the balance due to Sun Theater of ₩900 (₩6,000 × 15%) for March. Bin paid one-half the balance due and will remit the remainder on April 5.
	31	Received ₩9,000 cash from customers for admissions.

In addition to the accounts identified above, the chart of accounts includes No. 112 Accounts Receivable, No. 400 Service Revenue, No. 429 Rent Revenue, No. 610 Advertising Expense, No. 726 Salaries and Wages Expense, and No. 729 Rent Expense.

Instructions

a. Enter the beginning balances in the ledger. Insert a check mark (✓) in the reference column of the ledger for the beginning balance.

b. Journalize the March transactions. Sun records admission revenue as service revenue, rental of the concession stand as rent revenue, and film rental expense as rent expense.

c. Post the March journal entries to the ledger. Assume that all entries are posted from page 1 of the journal.

d. Prepare a trial balance on March 31, 2025.

d. Trial balance totals ₩64,100

Expand Your Critical Thinking

Financial Reporting Problem: TSMC, Ltd. (TWN)

CT2.1 The financial statements of **TSMC** are presented in Appendix A. The notes accompanying the statements contain the following selected accounts. The complete annual report, including the notes to the financial statements, is available at the company's website.

Accounts Payable	Income Tax Payable
Accounts Receivable	Finance Cost (Interest Expense)
Property, Plant, and Equipment	Inventories

Instructions

a. Answer the following questions.

1. What is the increase and decrease side for each account?
2. What is the normal balance for each account?

b. Identify the probable other account in the transaction and the effect on that account when:

1. Accounts Receivable is decreased.
2. Accounts Payable is decreased.
3. Inventories are increased.

c. Identify the other account(s) that ordinarily would be involved when:

1. Finance Cost (Interest Expense) is increased.

2. Property, Plant, and Equipment is increased.

Comparative Analysis Problem: Nestlé SA (CHE) vs. Delfi Limited (SGP)

CT2.2 **Nestlé**'s financial statements are presented in Appendix B. Financial statements of **Delfi Limited** are presented in Appendix C.

Instructions

a. Based on the information contained in the financial statements, determine the normal balance of the listed accounts for each company.

Nestlé	Delfi Limited
1. Inventories	1. Trade (Accounts) Receivable
2. Property, Plant, and Equipment	2. Cash and Cash Equivalents
3. Trade and Other Payables	3. Cost of Sales (Expense)
4. Finance Cost (Interest Expense)	4. Revenue

b. Identify the other account ordinarily involved when:

1. Trade (Accounts) Receivable is increased.
2. Salaries and Wages Payable (part of Other Payables) is decreased.
3. Property, Plant, and Equipment is increased.
4. Interest Expense (Finance Cost) is increased.

Real-World Focus

CT2.3 Much information about specific companies is available on the Internet. Such information includes basic descriptions of the company's location, activities, industry, financial health, and financial performance.

Instructions

Go to the **Yahoo! Finance** website and then type in a company name, or use the index to find company name. Choose **Profile** and then perform instructions (a)–(c) below. Next, click on the company's specific industry to identify competitors. Perform instructions (d)–(g) below.

a. What is the company's industry?

b. What was the company's total sales?

c. What was the company's net income?

d. What are the names of four of the company's competitors?

e. Choose one of these competitors.

f. What is this competitor's name? What were its sales? What was its net income?

g. Which of these two companies is larger by size of sales? Which one reported higher net income?

Decision-Making Across the Organization

CT2.4 Amy Torbert manages Hollins Riding Academy. The academy's primary sources of revenue are riding fees and lesson fees, which are paid on a cash basis. Hollins also boards horses for owners, who are billed monthly for boarding fees. In a few cases, boarders pay in advance of expected use. For its revenue transactions, the academy maintains the following accounts: No. 1 Cash, No. 5 Boarding Accounts Receivable, No. 27 Unearned Boarding Revenue, No. 51 Riding Revenue, No. 52 Lesson Revenue, and No. 53 Boarding Revenue.

The academy owns 10 horses, a stable, a riding corral, riding equipment, and office equipment. These assets are accounted for in accounts No. 11 Horses, No. 12 Building, No. 13 Riding Corral, No. 14 Riding Equipment, and No. 15 Office Equipment.

For its expenses, the academy maintains the following accounts: No. 6 Hay and Feed Supplies, No. 7 Prepaid Insurance, No. 21 Accounts Payable, No. 60 Salaries Expense, No. 61 Advertising Expense, No. 62 Utilities Expense, No. 63 Veterinary Expense, No. 64 Hay and Feed Expense, and No. 65 Insurance Expense.

Hollins maintains two equity accounts: No. 50 Share Capital—Ordinary and No. 51 Dividends.

During the first month of operations, an inexperienced bookkeeper was employed. Amy Torbert asks you to review the following eight entries of the 50 entries made during the month. In each case, the explanation for the entry is correct.

May 1	Cash	18,000	
	Share Capital—Ordinary		18,000
	(Invested £18,000 cash in business in exchange for ordinary shares)		
5	Cash	250	
	Riding Revenue		250
	(Received £250 cash for lessons performed)		
7	Cash	500	
	Boarding Revenue		500
	(Received £500 for boarding of horses beginning June 1)		
14	Riding Equipment	800	
	Cash		800
	(Purchased desk and other office equipment for £800 cash)		
15	Salaries Expense		
	Cash	440	
	(Declared and paid cash dividends)		440
20	Cash	148	
	Riding Revenue		184
	(Received £184 cash for riding fees)		
30	Veterinary Expense	75	
	Accounts Payable		75
	(Received bill of £75 from veterinarian for services rendered)		
31	Hay and Feed Expense	1,500	1,500
	Cash		
	(Purchased an estimated 2 months' supply of feed and hay on account for £1,500)		

Instructions

With the class divided into groups, answer the following.

a. Identify each journal entry that is correct. For each journal entry that is incorrect, prepare the entry that should have been made by the bookkeeper.

b. Which of the incorrect entries would prevent the trial balance from balancing?

c. What was the correct net income for May, assuming the bookkeeper reported net income of £4,600 after posting all 50 entries (and the only errors occurred in the items listed above)?

d. What was the correct cash balance at May 31, assuming the bookkeeper reported a balance of £12,475 after posting all 50 entries (and the only errors occurred in the items listed above)?

Communication Activity

CT2.5 Shandler Home Cleaners has two recurring transactions: billing customers for services rendered and paying employee salaries. For example, on March 15, bills totaling €6,000 were sent to customers and €2,000 was paid in salaries to employees.

Instructions

Write an email to your instructor that explains and illustrates the steps in the recording process for each of the March 15 transactions. Use the format illustrated in the text under the heading, "The Recording Process Illustrated."

Ethics Cases

CT2.6 Ellynn Kole is the assistant chief accountant at Doman Circuits, a manufacturer of computer chips and cellular phones. The company presently has total sales of €20 million. It is the end of the first quarter. Ellynn is hurriedly trying to prepare a trial balance so that quarterly financial statements can be prepared and released to management and the regulatory agencies. The total credits on the trial balance exceed the debits by €1,000. In order to meet the 4 p.m. deadline, Ellynn decides to force the debits and credits into balance by adding the amount of the difference to the

Equipment account. She chooses Equipment because it is one of the larger account balances; percentage-wise, it will be the least misstated. Ellynn "plugs" the difference! She believes that the difference will not affect anyone's decisions. She wishes that she had another few days to find the error but realizes that the financial statements are already late.

Instructions

a. Who are the stakeholders in this situation?

b. What are the ethical issues involved in this case?

c. What are Ellynn's alternatives?

CT2.7 If you haven't already done so, in the not-too-distant future you will prepare a résumé. In some ways, your résumé is like a company's annual report. Its purpose is to enable others to evaluate your past, in an effort to predict your future.

A résumé is your opportunity to create a positive first impression. It is important that it be impressive—but it should also be accurate. In order to increase their job prospects, some people are tempted to "inflate" their résumés by overstating the importance of some past accomplishments or positions. In fact, you might even think that "everybody does it" and that if you don't do it, you will be at a disadvantage.

Jay Ling, the president and CEO of a well-known electronics retailer, overstated his accomplishments by claiming that he had earned a bachelor's of science degree, when in fact he had not. Apparently, his employer had not done a background check to ensure the accuracy of his résumé. Should the company have fired him?

YES: The company is a publicly traded company. Investors, creditors, employees, and others doing business with the company will not trust it if its leader is known to have poor integrity. The "tone at the top" is vital to creating an ethical organization.

NO: Mr. Ling had been a company employee for 11 years. He had served the company in a wide variety of positions, and had earned the position of CEO through exceptional performance. While the fact that he lied 11 years earlier on his résumé was unfortunate, his service since then made this past transgression irrelevant. In addition, the company was in the midst of a massive restructuring, which included closing 700 of its 7,000 stores. It could not afford additional upheaval at this time.

Instructions

Write a response indicating your position regarding this situation. Provide support for your view.

All About You

CT2.8 Every company needs to plan in order to move forward. Its top management must consider where it wants the company to be in three to five years. Like a company, you need to think about where you want to be three to five years from now, and you need to start taking steps now in order to get there.

Instructions

Provide responses to each of the following items.

a. Where would you like to be working in three to five years? Describe your plan for getting there by identifying between five and 10 specific steps that you need to take.

b. In order to get the job you want, you will need a résumé. Your résumé is the equivalent of a company's annual report. It needs to provide relevant and reliable information about your past accomplishments so that employers can decide whether to "invest" in you. Do a search on the Internet to find a good résumé format. What are the basic elements of a résumé?

c. A company's annual report provides information about a company's accomplishments. In order for investors to use the annual report, the information must be reliable; that is, users must have faith that the information is accurate and believable. How can you provide assurance that the information on your résumé is reliable?

d. Prepare a résumé assuming that you have accomplished the five to 10 specific steps you identified in part (a). Also, provide evidence that would give assurance that the information is reliable.

Considering Environmental, Social, and Governance Reporting

CT2.9 Auditors provide a type of certification of company financial statements. Certification is used in many other aspects of business as well. For example, it plays a critical role in the sustainability movement. The February 7, 2012, issue of the *New York Times* contained an article by S. Amanda Caudill entitled "Better Lives in Better Coffee," which discusses the role of certification in the coffee business.

Instructions

Conduct an Internet search to locate and read the article, and then answer the following questions.

a. The article mentions three different certification types that coffee growers can obtain from three different certification bodies. Using financial reporting as an example, what potential problems might the existence of multiple certification types present to coffee purchasers?

b. According to the author, which certification is most common among coffee growers? What are the possible reasons for this?

c. What social and environmental benefits are coffee certifications trying to achieve? Are there also potential financial benefits to the parties involved?

A Look at U.S. GAAP

LEARNING OBJECTIVE 5

Compare the procedures for the accounting process under IFRS and U.S. GAAP.

Companies that use GAAP follow the same set of procedures and records to keep track of transaction data as do IFRS companies. Thus, the material in Chapter 2 dealing with the account, general rules of debit and credit, and steps in the recording process—the journal, ledger, and chart of accounts—is the same under both GAAP and IFRS.

Key Points

- Both the IASB and FASB go beyond the basic definitions provided in this text for the key elements of financial statements, that is, assets, liabilities, equity, revenues, and expenses. The more substantive definitions, using the FASB definitional structure, are provided in the Chapter 1 *A Look at U.S. GAAP* section.
- For a period of time, the U.S. Securities and Exchange Commission (SEC) was considering adopting IFRS. During this period, the U.S. SEC indicated the following items should be considered in this decision.
  - Whether IFRS is sufficiently developed and consistent in application.
  - Whether the IASB is sufficiently independent.
  - Whether IFRS is established for the benefit of investors.
  - The issues involved in educating investors about IFRS.
  - The impact of a switch to IFRS on U.S. laws and regulations.
  - The impact on companies including changes to their accounting systems, contractual arrangements, company governance, and litigation.
  - The issues involved in educating accountants, so they can prepare statements under IFRS.
- It now appears that the SEC will not adopt IFRS but will permit foreign companies that have securities issued in U.S. markets to provide their financial information to the SEC using IFRS.

Similarities

- A trial balance under GAAP follows the same format as shown in the text.
- As shown in the text, currency signs are typically used only in the trial balance and the financial statements. The same practice is followed under GAAP, using the U.S. dollar. For example, the following income statement for **Apple Inc.** (USA) is denominated in its own currency—the U.S. dollar.

Apple Inc.
Consolidated Statement of Operations
For the Year Ended September 26, 2020
(in millions except per share data)

Net sales	$274,515
Cost of sales	169,559
Gross margin	104,956
Operating expenses:	
Research and development	18,752
Selling, general and administrative	19,916
Total operating expenses	38,668
Operating income	66,288
Other income/(expense), net	803
Income before provision for income taxes	67,091
Provision for income taxes	9,680
Net income	$ 57,411

Differences

- The statement of financial position is often called the balance sheet in the United States.
- Rules for accounting for specific events sometimes differ across countries. For example, IFRS companies rely less on historical cost and more on fair value than U.S. companies. Despite the differences, the double-entry accounting system is the basis of accounting systems worldwide.

GAAP Practice

GAAP Self-Test Questions

1. Which statement is **correct** regarding GAAP?

a. GAAP reverses the rules of debits and credits, that is, debits are on the right and credits are on the left.

b. GAAP uses the same process for recording transactions as IFRS.

c. The chart of accounts under GAAP is different because revenues follow assets.

d. None of the answer choices is correct.

Answer

2. A trial balance:

a. is the same under GAAP and IFRS.

b. proves that transactions are recorded correctly.

c. proves that all transactions have been recorded.

d. will not balance if a correct journal entry is posted twice.

Answer

3. One difference between GAAP and IFRS is that:

a. IFRS uses accrual-accounting concepts and GAAP uses primarily the cash basis of accounting.

b. GAAP uses a different posting process than IFRS.

c. IFRS uses more fair value measurements than GAAP.

d. the limitations of a trial balance are different between GAAP and IFRS.

Answer

4. The general policy for using proper currency signs (dollar, yen, pound, etc.) is the same for both GAAP and this text. This policy is as follows:

a. Currency signs only appear in ledgers and journal entries.

b. Currency signs are only shown in the trial balance.

c. Currency signs are shown for all compound journal entries.

d. Currency signs are shown in trial balances and financial statements.

Answer

GAAP Exercise

GAAP2.1 Describe some of the issues the U.S. SEC must consider in deciding whether the United States should adopt IFRS.

GAAP Financial Reporting Problem: Apple Inc. (USA)

GAAP2.2 The financial statements of **Apple** are presented in Appendix D. The complete annual report, including the notes to its financial statements, is available at the company's website.

Instructions

a. Apple has the following selected accounts:

Accounts Payable	Inventories
Accounts Receivable	Net Sales
Property, Plant, and Equipment, net	Research and Development

1. What is the increase and decrease side of each account?
2. What is the normal balance for each account?

b. Identify the probable other account in the transaction and the effect on that account when:

1. Accounts Receivable is decreased.
2. Accounts Payable is decreased.
3. Inventories is increased.