

Chapter 2 • Analyzing Business Transactions

TEACHING OBJECTIVES

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

SECTIONS

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

CHAPTER OVERVIEW/ LEARNING OBJECTIVES

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

- 2-1. This chapter records in equation form the financial effects of a business's transactions.
- 2-2. This chapter introduces and defines assets, liabilities and owner equity accounts. It evaluates the relationship between the accounts in equation form.
- 2-3. The chapter analyzes the effects of business transactions on a firm's assets, liabilities, and owner's equity, and records the effects of transactions using the accounting equation.
- 2-4. This chapter introduces the *Income Statement*. The *Income Statement* summarizes changes in owner's equity that result from revenue and expenses. The difference between revenue and expenses is the net income or net loss of the business for the period.
- 2-5. The *Statement of Changes in Owner's Equity* and a *Balance Sheet* are discussed. Changes in owner's equity for the period are summarized on the Statement of Owner's Equity.

- 2-6. The *Balance Sheet* shows assets, liabilities, and owner's equity on a given date. At the beginning of the chapter, there is a short paragraph about Southwest Airlines. Let's read this together. . .



Ask. . . "In what ways do you think a happy workforce contributes to the bottom line, or net profit, of the company?"

Answer--- Answers will vary but students should recognize that happy employees are more productive and present a positive image to the company. Happy employees are also loyal which leads to lower employee turnover, and lower training and recruiting expenses. Happy employees are much less likely to steal from the company, and of course, happy employees mean happy customers who become repeat customers.

- **FAST FACTS** Southwest Airlines opened in 1971 with three planes flying between Houston, Dallas, and San Antonio. Southwest has posted a profit for 37 consecutive years. They fly almost 100 million passengers each year.
- They stress the lowest possible fares and insure that their customers have a good time getting to their destination.
- For fiscal year 2012, the company's net income was \$ 417 million, excluding special items.

Chapter 2
Analyzing Business Transactions

Section 1: Property and Financial Interest
Section Objectives

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

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


Meet Wells' Consulting Services

Wells' Consulting

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

Steps to analyze the effect of a business transaction

- Describe the financial event.
 - Identify the property.
 - Identify who owns the property.
 - Determine the amount of increase or decrease.
- Make sure the equation is in balance.



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

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

Business Transaction

Carolyn Wells withdrew \$100,000 from personal savings and deposited it in a new checking account in the name of Wells' Consulting Services.


Analysis:

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

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


The owner invested cash into the business


Property	=	Financial Interest
	Cash	Carolyn Wells, Capital
Initial investment cash	+ \$100,000	
Initial increased equity		+ \$100,000
New balances	\$100,000	= \$100,000

 Carolyn Wells now has \$100,000 equity in Wells' Consulting Services.

Section 1. PROPERTY AND FINANCIAL INTEREST

A. Beginning with Analysis

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

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

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

Objective 2-1

◆ Starting a Business

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

◆ DESCRIBE THESE ANALYSIS STEPS:

1. Explain to students that analysis (determining whether a financial event, like a purchase, sale, payment, or receipt is a business transaction) is the first step of the recording process.
2. The equation must always be in balance.

The company buys equipment for \$5,000 cash

	Property		Financial Interest	
	Cash	Equipment	Accounts Payable	Common Stock, Capital
Previous balances	\$100,000	=		\$100,000
Net Purchased equipment		+ \$5,000		
Net Paid cash	- \$5,000			
New balances	\$95,000	+ \$5,000	=	\$100,000

◆ Purchasing Equipment for Cash

- Remind students that, when recording the effects of transactions in equation form, the value of property acquired by a business is offset by any claim against the property (rights to proceeds from a sale of property).
- Emphasize that a claim is never asset specific. That is, assets are thought of as being a pool of items.

◆ Purchasing Equipment on Credit

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

	Property		Financial Interest	
	Cash	Equipment	Accounts Payable	Common Stock, Capital
Previous balances	\$95,000	+ \$5,000	=	\$100,000
Net Purchased equip.		+ \$6,000		
Net Incurred debt			- \$6,000	
New balances	\$95,000	+ \$11,000	=	\$106,000

Notice the new claim against the firm's property - the creditor's claim of \$6,000.

- Define *Accounts Payable*. (Amounts that a business must pay in the future)
- Explain that purchasing an asset on credit:
 1. Increases the asset—the *Property side* of the equation.
 2. Increases the amount owed by the business—the *Financial Interest side* of the equation.
- Point out that the equation must always remain in balance.

◆ Purchasing Supplies

The firm purchases supplies for \$1,500 cash

	Property				Financial Interest	
	Cash	Supplies	Equipment	Accounts Payable	Equity	Equity
Physical Address	\$50,000		\$10,000	\$0	\$0	\$100,000
MRP (Cash)		\$1,500				
MRP (Supplies)						
MRP (Equipment)						
New Balance	\$50,000	\$1,500	\$10,000	\$0	\$0	\$100,000
	\$106,000					\$106,000

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

◆ Paying A Creditor

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

	Property				Financial Interest	
	Cash	Supplies	Equipment	Accounts Payable	Equity	Equity
Physical Address	\$50,000		\$10,000	\$0	\$0	\$100,000
MRP (Cash)						
MRP (Supplies)						
MRP (Equipment)						
New Balance	\$47,500		\$10,000	\$0	\$0	\$100,000
	\$103,500					\$103,500

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

◆ Renting Facilities

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

	Property				Financial Interest	
	Cash	Supplies	Prepaid Rent	Equipment	Accounts Payable	Equity
Physical Address	\$50,000			\$10,000	\$0	\$100,000
MRP (Cash)						
MRP (Supplies)						
MRP (Equipment)						
New Balance	\$42,000		\$8,000	\$10,000	\$0	\$100,000
	\$103,500					\$103,500

- Point out that the rent in this transaction is paid in advance.
- Explain that the right to occupy the facility is considered a form of property.
- Explain that this transaction:
 1. Increases the asset, *Prepaid Rent*.
 2. Decreases the asset, *Cash*.
- Point out that the equation remains in balance.

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

Assets, Liabilities, and Owner's Equity

QUESTION:
What are assets?

ANSWER:
Assets are property owned by a business.

Liabilities and Equity

QUESTION:
What are liabilities?

ANSWER:
Liabilities are debts or obligations of a business

QUESTION:
What is owner's equity?

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

The Balance Sheet

QUESTION:
What is a Balance Sheet?

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

The Balance Sheet

Wend Consulting Services			
Balance Sheet			
November 30, 2018			
Assets	Liabilities	Equity	
Cash	Accounts Payable	Owner's Equity	
Accounts Receivable	Notes Payable	Retained Earnings	
Prepaid Insurance	Other Payables		
Other Assets	Other Payables		
Total Assets	Total Liabilities	Total Equity	

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

Property equals Financial Interest

Objective 2-2

B. Assets, Liabilities, and Owner's Equity



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

--List these on the board.



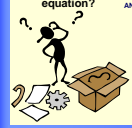
Then ask, "How will you acquire these items?" List the responses on the board.

- ◆ Explain to students that everything listed will be categorized as an asset or a liability. The difference is owner's equity.
- ◆ Have students categorize the items.

The Fundamental Accounting Equation

QUESTION:
What is the fundamental accounting equation?

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



Chapter 2

Analyzing Business Transactions

Section 2: The Accounting Equation and Financial Statements

Section Objectives

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

2-4 Prepare an income statement.

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

The Fundamental Accounting Equation

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

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

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

Objective 2-3

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

Objective 2-3

Section 2. THE ACCOUNTING EQUATION AND FINANCIAL STATEMENTS

A. The Fundamental Accounting Equation

Write the accounting equation on the board, then

- Explain to students that accountants show the relationship between assets, liabilities, and owner's equity in an equation.
- Assets are on the left and liabilities and owner's equity (claims against the assets), are on the right.
- The two sides of the equation must always balance.
- Emphasize that assets are things that an individual or a business owns that have value.



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

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

Expenses	
QUESTION:	What is an expense?
ANSWER:	An expense is an outflow of cash, use of other assets, or incurring of a liability.

◆ Earning Revenue and Incurring Expenses

- Explain that revenue is the inflow of assets (cash or accounts receivable) as a result of the sale of goods or services.
- Explain that expenses are the costs associated with earning revenue.
- In the beginning, students might get confused by the terms expense and liability.
- Point out that an expense is something that was used up and can actually create a liability if it is not paid off in cash. A liability is a debt owned by the business and usually ends with the word "payable"—Accounts Payable is a good example.

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

	Assets		Liabilities		Owner's Equity	
	Cash	Accounts Receivable	Accounts Payable	Notes Payable	Common Stock	Retained Earnings
Prepaid expenses	\$10,000					
Accounts receivable		\$26,000				
Accounts payable			\$10,000			
Notes payable				\$10,000		
Common stock					\$100,000	
Retained earnings						\$100,000
Total	\$10,000	\$26,000	\$10,000	\$10,000	\$100,000	\$100,000


◆ **Selling Services for Cash**

- Explain that this transaction:
 1. Increases the asset, *Cash*.
 2. Increases the revenue.
- Point out that the equation remains in balance.
- Point out that revenues are recorded in a separate column under owner's equity.

The company performs services on account for \$11,000

	Assets		Liabilities		Owner's Equity	
	Cash	Accounts Receivable	Accounts Payable	Notes Payable	Common Stock	Retained Earnings
Prepaid expenses	\$10,000					
Accounts receivable		\$11,000				
Accounts payable			\$10,000			
Notes payable				\$10,000		
Common stock					\$100,000	
Retained earnings						\$100,000
Total	\$10,000	\$11,000	\$10,000	\$10,000	\$100,000	\$100,000


◆ **Selling Services on Credit**

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

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

	Assets		Liabilities		Owner's Equity	
	Cash	Accounts Receivable	Accounts Payable	Notes Payable	Common Stock	Retained Earnings
Prepaid expenses	\$10,000					
Accounts receivable		\$11,000				
Accounts payable			\$10,000			
Notes payable				\$10,000		
Common stock					\$100,000	
Retained earnings						\$100,000
Total	\$10,000	\$11,000	\$10,000	\$10,000	\$100,000	\$100,000

◆ **Collecting Receivables**

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

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

Assets		Liabilities		Owner's Equity	
Cash	Expenses	Accounts Payable	Notes Payable	Common Stock	Retained Earnings
\$100,000	\$0	\$0	\$0	\$100,000	\$0
-8,000	8,000	0	0	0	8,000
\$92,000	\$8,000	\$0	\$0	\$100,000	\$8,000

◆ Paying Employees Salaries

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

The firm pays \$650 for utilities expenses

Assets		Liabilities		Owner's Equity	
Cash	Expenses	Accounts Payable	Notes Payable	Common Stock	Retained Earnings
\$100,000	\$0	\$0	\$0	\$100,000	\$0
-650	650	0	0	0	650
\$99,350	\$650	\$0	\$0	\$100,000	\$650

◆ Paying Utilities Expense

- Explain that this transaction:
 1. Decreases the asset, *Cash*.
 2. Increases the Expenses column which causes Owner's Equity to go down.
- Point out that the equation remains in balance.

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

Assets		Liabilities		Owner's Equity	
Cash	Expenses	Accounts Payable	Notes Payable	Common Stock	Retained Earnings
\$100,000	\$0	\$0	\$0	\$100,000	\$0
-5,000	0	0	0	0	-5,000
\$95,000	\$0	\$0	\$0	\$100,000	-\$5,000

◆ Effects of Owner's Withdrawals

- Explain that the funds taken from the business are for the owner's *personal use* and not an expense of the business, but a decrease in owner's equity.
- In accounting, owner's equity is the amount remaining after the value of all liabilities is subtracted from the value of all assets. That is, it is the owner's right to the financial interest in the business.

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

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

Objective 2-4

B. The Income Statement

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

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



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

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

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

Objective 2-4 Prepare an Income Statement

QUESTION:
What is an income statement?

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

The income statement has a three-line heading. The third line shows that the report covers operations over a period of time.

Wells' Consulting Services	
Income Statement	
Month Ended December 31, 2016	
Revenue	
Fees Income	\$47,000.00
Expenses	
Salaries Expense	8,000.00
Utilities Expense	.650.00
Total Expenses	<u>8,650.00</u>
Net Income	<u>\$ 38,350.00</u>

The income statement reports revenue.

Wells' Consulting Services	
Income Statement	
Month Ended December 31, 2016	
Revenue	
Fees Income	\$47,000.00
Expenses	
Salaries Expense	8,000.00
Utilities Expense	.650.00
Total Expenses	<u>8,650.00</u>
Net Income	<u>\$ 38,350.00</u>

The income statement also reports expenses.

Wells' Consulting Services	
Income Statement	
Month Ended December 31, 2016	
Revenue	
Fees Income	\$47,000.00
Expenses	
Salaries Expense	8,000.00
Utilities Expense	.650.00
Total Expenses	<u>8,650.00</u>
Net Income	<u>\$ 38,350.00</u>

The result is net income or net loss for the period.

Wells' Consulting Services	
Income Statement	
Month Ended December 31, 2016	
Revenue	
Fees Income	\$47,000.00
Expenses	
Salaries Expense	8,000.00
Utilities Expense	.650.00
Total Expenses	<u>8,650.00</u>
Net Income	<u>\$ 38,350.00</u>

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

A Statement of Owner's Equity

Wells' Consulting Services Statement of Owner's Equity Month Ended December 31, 2016	
Carolyn Wells, Capital, December 1, 2016	\$100,000.00
Net Income for December	\$38,350.00
Less Withdrawals for December	(5,000.00)
Increase in Capital	33,350.00
Carolyn Wells, Capital, December 31, 2016	<u>\$133,350.00</u>

Objective 2-5

C. Statement of Owner's Equity and the Balance Sheet

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

- It would include:
 1. Investments
 2. Net income or *net loss* of the business
 3. Any withdrawals the owner made.
- Point out the three-line heading.
- Emphasize the importance of including the *beginning* capital balance and the *ending* capital balance.

The Balance Sheet

Wells' Consulting Services Balance Sheet December 31, 2016	
Assets	Liabilities
Cash	Accounts Payable
Accounts Receivable	Owner's Equity
Supplies	Carolyn Wells, Capital
Prepaid Rent	Total Liabilities and Owner's Equity
Equipment	
Total Assets	

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

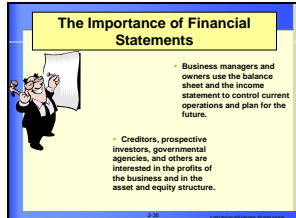
The Balance Sheet shows:

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





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


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



D. The Importance of Financial Statements


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

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

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

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

Managerial Implications:

 Ask students, "If you were buying a business, what would *you* look for in the company's financial statements?"

Answer—Answers will vary. Students should mention total assets and the type of assets, the liabilities, the business would be responsible for, and whether the business is making a profit.

Financial statements are prepared in a specific order:

- 1st Income Statement
- 2nd Statement of Owner's equity
- 3rd Balance Sheet

Financial statements :

The screenshot displays three financial statements for 'Miles Consulting Services' for the period ending December 31, 2018. The first statement is the Income Statement, which shows a net income of \$1,000.00. This net income is transferred to the Statement of Owner's Equity, which shows an ending capital balance of \$1,000.00. This ending capital balance is then transferred to the Balance Sheet, which shows a total of \$1,000.00. Red boxes and arrows in the screenshot illustrate these transfers between the statements.

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