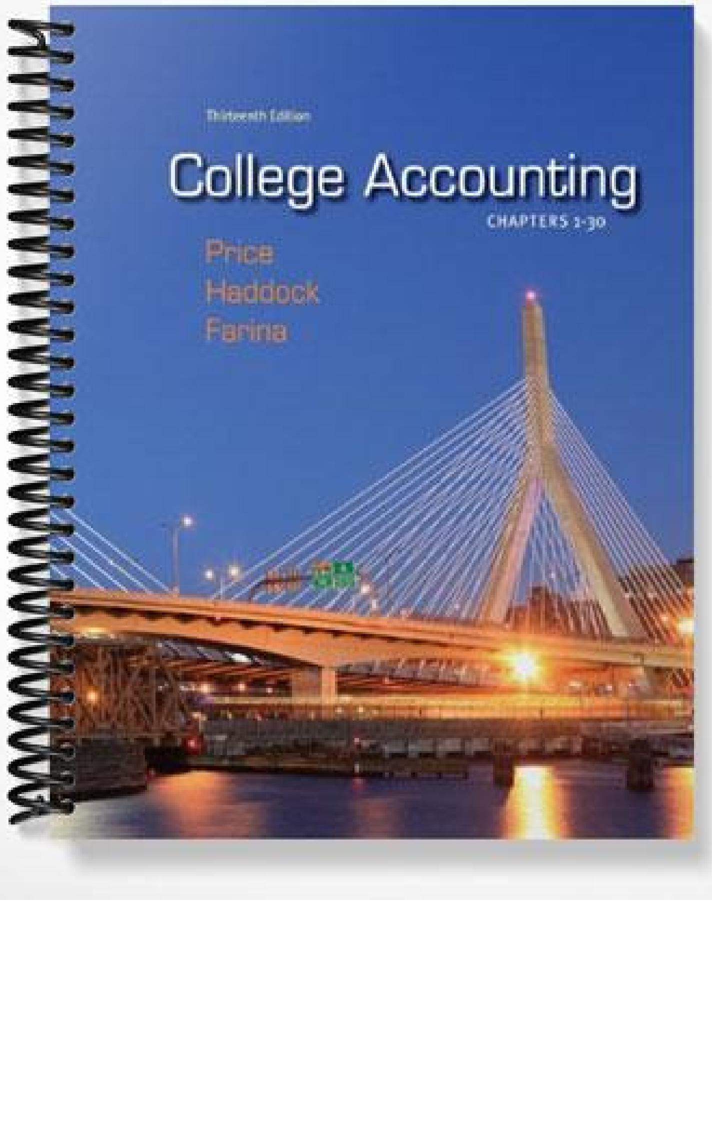
SOLUTIONS MANUAL



Chapter 2 • Analyzing Business Transactions

TEACHING OBJECTIVES

1) Record in equation form the financial effects of a business transaction.
2) Define, identify, and understand the relationship between asset, liability, and owner's equity accounts.
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.
4) Prepare an income statement.
5) Prepare a statement of owner's equity and a balance sheet.
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.

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

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

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.

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.

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.

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

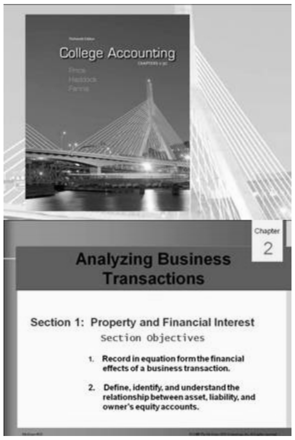
At the beginning of the chapter, there is a short paragraph about Southwest Airlines. Let's read this together. . .

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 repeated 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 the fiscal year 2009 the company's net income was $ 99 million.



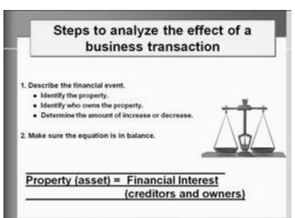
Section 1. PROPERTY AND FINANCIAL INTEREST

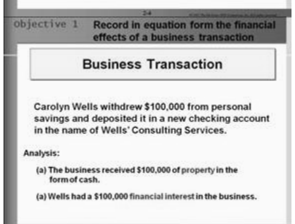
A. Beginning with Analysis

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 1

- ♦ **Starting a Business**

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

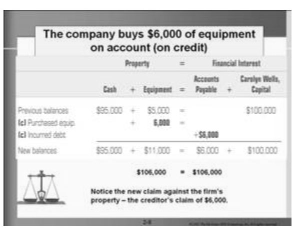
> ♦ **DESCRIBE THESE ANALYSIS STEPS:**
>
> 1. **Explain to students that analysis (determining whether a financial event, like a purchase, sale, payment, or receipt is a business transaction) is the first step of the recording process.**
> 2. **The equation must always be in balance.**

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

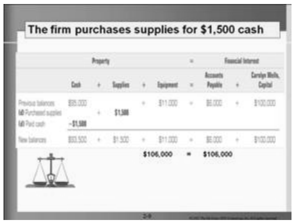
- Remind students that, when recording the effects of transactions in equation form, the value of property acquired by a business is offset by any claim against the property (rights to proceeds from a sale of property).
- Emphasize that a claim is never asset specific. That is, assets are thought of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

♦ <u>Purchasing Equipment on Credit</u>

- 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 remains in balance.



♦ Purchasing Supplies

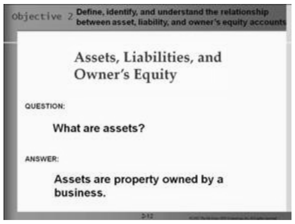
- Explain that this transaction:
  1. Increases the asset, *Supplies.*
  2. Decreases the asset, *Cash.*
- Point out that the equation remains in balance.

♦ Paying A Creditor

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

♦ Renting Facilities

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

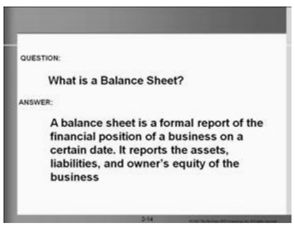


Objective 2

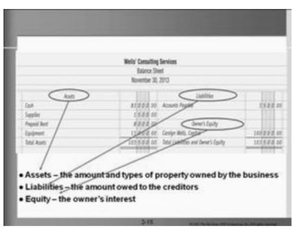
B. Assets, Liabilities, and Owner's Equity

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

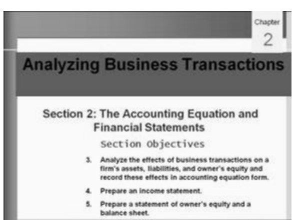
—List these on the board.

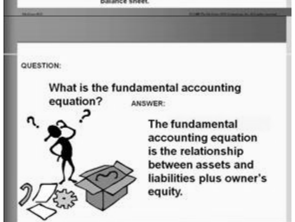


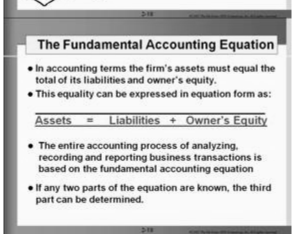
Then ask, "How will you acquire these items?" List the responses on the board.



- 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.







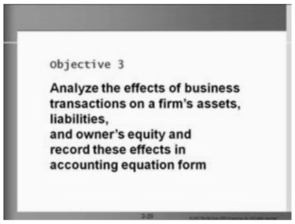
Objective 3

Section 2. THE ACCOUNTING EQUATION AND FINANCIAL STATEMENTS

A. The Fundamental Accounting Equation

Write the accounting equation on the board, then

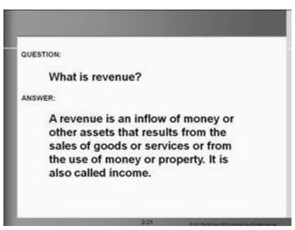
- Explain to students that accountants show the relationship between assets, liabilities, and owner's equity in an equation.

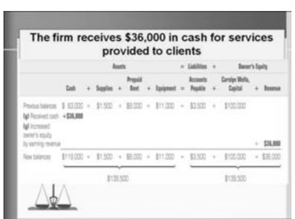


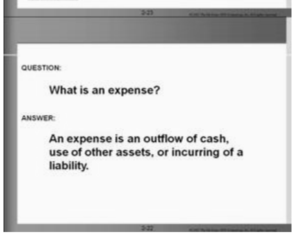
Assets are on the left and ***liabilities*** and ***owner's equity*** (claims against the assets), are on the right.

- The two sides of the equation <u>must always balance.</u>
- 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*.







♦ **<u>Earning Revenue and Incurring Expenses</u>**

- 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.

♦ <u>**Selling Services for Cash**</u>

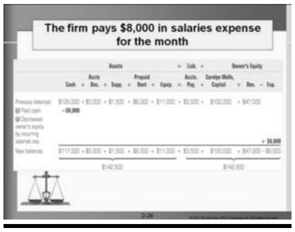
- Explain that this transaction:
  1. Increases the asset, *Cash.*
  2. Increases the revenue.
- Point out that the equation remains in balance.
- Point out that revenues are recorded in a separate column under owner's equity.

♦ <u>**Selling Services on Credit**</u>

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

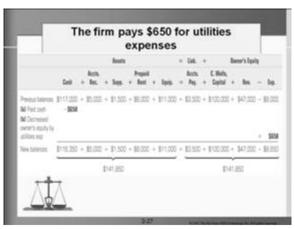
♦ <u>**Collecting Receivables**</u>

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



♦ **<u>Paying Employees Salaries</u>**

- 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.



♦ **<u>Paying Utilities Expense</u>**

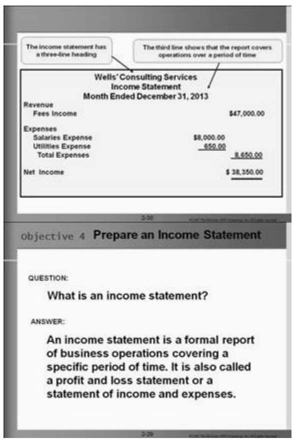
- Explain that this transaction:
  1. Decreases the asset, *Cash.*
  2. Increases the Expenses column which causes Owner's Equity to go down.
- Point out that the equation remains in balance.

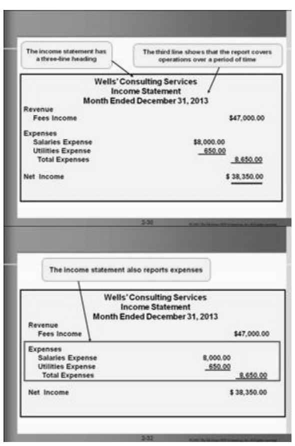
♦ **<u>Effects of Owner's Withdrawals</u>**

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

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

- After recording all of these transactions, the Accounting Equation still balances.





<u>Objective 4</u>

B. The Income Statement

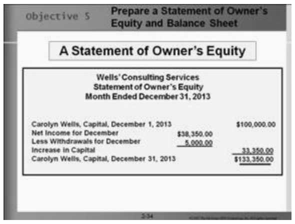
Explain to students that the <u>*income statement*</u> is the *first* in a series of three reports that together, provide a business owner with all of the business's financial information.

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

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

- Explain that the <u>heading</u> 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

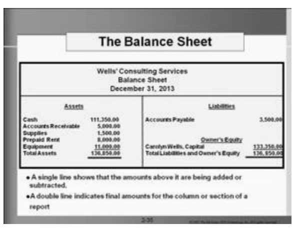


Objective 5

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

The <u>*statement of owner's equity*</u> 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 <u>three-line heading</u>.
- Emphasize the importance of including the *beginning* capital balance and the *ending* capital balance.

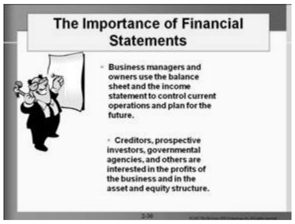


The Balance Sheet shows:

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

Ask students, "What is the difference in the <u>heading</u> 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**).

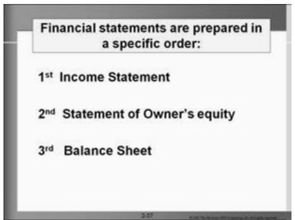
Ask students, "Which statement would provide information about how much the owner invested or withdrew during the period?"—(**The statement of owner's equity**).

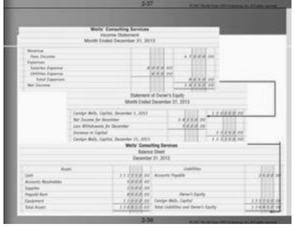
Financial statements and other records are necessary so that business-people can make good decisions. . .

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.

POWER POINT	Section	Topics/Discussion





- 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