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PREFACE

Accounting the Easy Way is designed for individuals with some knowledge of accounting as well as those with none at all. This book presents the subject matter in a logical sequence, with exercises after every appropriate topic within each chapter. These exercises allow you to apply knowledge just learned and then check your work against the solutions at the back of the book. This fourth edition also includes supplementary exercises for each chapter, presented together in a separate section at the back of the book. The first supplementary exercise for each chapter consists of questions relating to information presented in the text for that chapter. Your ability to answer the questions to the first supplementary exercise provides an indication of how well you understand the material in the chapter. The remaining supplementary exercises are meant to be used to reinforce your understanding or to assist you in cases in which the initial exercise proved inadequate. The organization of these supplementary exercises is similar to the original exercises presented in the body of the text. Key figures are provided, where appropriate, to assist in verifying whether you answered the supplementary exercises correctly. Finally, a comprehensive glossary includes definitions of important accounting terms.

Since no prior knowledge of accounting is needed to master the subject matter in *Accounting the Easy Way*, the student will find this book an excellent self-study guide and an invaluable companion to any textbook required in a survey-level college course on principles of accounting. Unlike traditional college textbooks that present accounting principles for various forms of business organizations at the same time, *Accounting the Easy Way* concentrates on accounting for sole proprietorships and thus gives a simpler, more direct presentation of the subject. The partnership and corporation forms of business organizations are discussed briefly in the last two chapters of the book.

This fourth edition of *Accounting the Easy Way* presents the most up-to-date information on the new tax code as it relates to this elementary course. The most up-to-date withholding tax tables are used and illustrated. This book may also be used as a college accounting textbook on the high school level. The presentation and organization meets the traditional first term college accounting course curriculum.

I would like to take this opportunity to thank my wife, Amy, for her continuing support and encouragement in the original writing and in this most recent revision of the book. A special thanks to my son Howard for his invaluable patience and assistance in instructing me in the use of the microcomputer and word processing software used in the original and latest edition of this book.

Peter J. Eisen

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CHAPTER 1

THE ACCOUNTING EQUATION

Some Basics

WHAT IS ACCOUNTING?

Accounting is the art of organizing, maintaining, recording, and analyzing financial activities. Accounting is generally known as the "language of business." The accountant translates this accounting information into meaningful terms that are used by interested parties. Every organization, whether organized for profit, nonprofit, charitable, religious, or governmental purposes requires accountants.

Accounting may be divided into three areas: (1) public accounting, (2) private accounting, and (3) governmental accounting. The public accountant, usually an employee of a CPA firm, is employed as an independent contractor by a business to perform an auditing function: to review the accounting system used by the business, check the correctness of financial statements, and give an opinion. The public accountant also prepares income tax returns and provides management advisory services. The private accountant, usually employed by a business, records business activities and prepares periodic financial statements. The governmental accountant performs the same functions as a private accountant but is employed by a federal, state, or local governmental agency.

WHO USES ACCOUNTING INFORMATION?

Accounting information is used by everyone. The manager of an organization, who is charged with the responsibility of seeing that the enterprise is properly directed, calls upon the accounting information provided to make appropriate decisions. Investors in an enterprise need information about the financial status and future prospects of an organization. Bankers and suppliers grant loans and extend credit to organizations based on their financial soundness as evidenced by accounting information. Customers are concerned about a company's ability to provide a product or service. Employees are concerned about the ability of the employer to pay wages and fringe benefit packages.

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WHAT INFORMATION DOES AN ACCOUNTANT GATHER?

The accountant keeps track of all "business transactions." A business transaction is any business activity that affects what a business owns or owes, as well as the ownership of that business.

What Are Assets?

Those things that are owned by any business organization are known as ASSETS. In order for an item to be considered an asset, it must meet two requirements: (1) it must be owned by the organization, and (2) it must have money value. OWNERSHIP is the exclusive right to possess, use, enjoy, and dispose of property. MONEY VALUE exists if a buyer is willing to pay money to a seller for the property.

EXERCISE 1 From the following list of items, indicate by checking the appropriate box which items are or are not assets.

Item	*Yes*	*No*
Cash		
Automobile		
Rented Apartment		
Checks		
Computer		
Library Book On Loan		
Clothing		
Postage Stamps		
Grocery List		
Food		

EXERCISE 2 Prepare a list of ten assets that you personally own. You may include the assets listed in Exercise 1, but attempt to list as many other personal assets as you can.

EXERCISE 3 Prepare a list of ten assets that a business organization would own. Attempt to list business assets that an individual might not have.

KEEPING TRACK OF ASSETS

Since there apparently are so many different kinds of assets, how does the accountant keep track of all of the assets? The accountant does not

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keep track of all of the assets individually, but rather combines assets of a similar nature into common groups. For example, an individual or business organization may have such assets as coins, bills, money orders, and checks. These assets would be placed in a category or grouping known as CASH. Thus, any money, regardless of its actual form, would be known and categorized as cash. Cash also includes money in bank accounts of the individual that is available for payment of bills.

EXERCISE 4

Test your ability to assign specific assets to categories. Place the assets listed below under the asset category headings that follow.

Traveler's checks, tables, truck, typewriter, adding machine, lamp, pencils, chairs, stationery, wrapping paper, automobiles, coins, money in bank, light bulbs, desk, pens, currency, showcases, computer, software programs, computer printer, and toner cartridge.

Cash	*Office Supplies*	*Furniture and Fixtures*	*Office Equipment*	*Delivery Equipment*

1. What is the difference between office supplies and office equipment?
2. A toner cartridge is considered an office supply, even though it is an integral part of the computer printer. Why?
3. Will we replace a typewriter as frequently as a typewriter ribbon? Why or why not?
4. What type of asset is a supply? (Short-life or long-life?)
5. What type of asset is a computer? (Short-life or long-life?)

TYPES OF ASSETS

As the previous exercises indicated, assets may take many forms. While they may be grouped together into categories as in Exercise 4, they may also be considered to be tangible and intangible assets as well. A tangible asset is one that can be readily seen, and possibly touched, such as those previously illustrated. They are physical assets. An intangible asset is without physical qualities, but has a value based on rights or privileges belonging to the owner.

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The assets of an organization are usually divided into four categories: (1) current assets, (2) investments, (3) property, plant, and equipment, and (4) intangible assets.

CURRENT ASSETS are defined as cash and other assets that can reasonably be expected to be converted to cash, used up, or sold within one year or less. Examples of current assets include cash, accounts receivable (obligations due from customers), and supplies.

INVESTMENTS are generally of a long-term nature, are not used in the normal operations of the organization and are not expected to be converted to cash within the year. Examples of investments are stocks and bonds of other organizations.

PROPERTY, PLANT, AND EQUIPMENT are long-term or long-life assets that are used in the continuing operations of the organization and are expected to be used by the organization for more than a year. These kinds of assets are also known as "Plant Assets." Examples of these assets are land, building, machinery, and equipment.

INTANGIBLE ASSETS are usually of a long-term nature and have no physical substance but are of value to the owners of the organization. Examples of these assets are patents, copyrights, goodwill, franchises, and trademarks.

EXERCISE 5

Place the following assets in the appropriate columns of the form following them: cash in bank, office equipment, First National City bonds, patents, accounts receivable, office supplies, notes receivable (due in ninety days), building, office machines, furniture and fixtures, mortgage notes receivable (due in six years), store equipment, petty cash, goodwill, factory supplies, and merchandise.

Current Assets	*Investments*	*Plant Assets*	*Intangible Assets*

A COMMON WAY TO EXPRESS ASSETS

We have indicated that the accountant keeps track of all business transactions. So far, the only business transactions we have discussed are things that the organization owns, namely assets. In order to keep track of these assets, there must be a common way of expressing these assets. The common way of expressing the value of items in a business is known as the MONETARY PRINCIPLE. All business transactions are recorded in terms of money. Money is the only factor that is common to all assets as well as to other items we will shortly be dis-

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cussing. If we were to say that we have the asset "office supplies," the accountant would express the ownership of this asset in terms of a money value assigned to it. The money value assigned would be based on what the office supplies had cost when they were purchased. If we acquired office supplies that had cost us $50, we would then say that the value of the asset office supplies is $50. All things owned by and owed to an organization, as well as the ownership of the organization, will be expressed in terms of money value. Money or cash becomes the common denominator in presenting accounting information.

Determining Money Value of Assets

In the case of the office supplies illustrated, the value assigned was based on the cost of the item. This is known as the COST PRINCIPLE. The cost assigned to the asset not only includes the purchase price, but also transportation charges, installation charges, and any other costs associated with placing the asset into use by the organization.

While every form of organization previously mentioned uses accounting information, we will assume from this point on that we are dealing with a profit-making business. We will further assume that the business is that of a single owner (also proprietorship). A SOLE PROPRIETORSHIP is a business that is formed by one individual. This individual is considered the owner of the business and receives any profits that the business earns and sustains any losses that the business may incur. The assets which the business owns are separate and apart from the assets that the owner may personally own. This is known as the BUSINESS ENTITY CONCEPT.

EXERCISE 6 Mr. Regal, the owner of a limousine service, purchases an automobile from a local car dealer. The purchase price of the automobile is $32,450. There are make-ready charges of $385, delivery charges of $265, and applicable state sales tax amounting to $2,731.

1. Determine the cost at which the new automobile should be recorded on the books of Mr. Regal's business.
2. If, upon leaving the dealership, Mr. Regal was offered $35,500 for the automobile, at what price should the new automobile be recorded on his records? Why?
3. Does Mr. Regal own the asset automobile? Why or why not?

EXERCISE 7 Mr. Glenn is negotiating to buy a parcel of property for his business. The seller of the property is asking $170,000 for the property. The assessed value of the property for property tax purposes is $125,000. The property is presently insured by the owner for $135,000. Mr. Glenn originally offered the seller $130,000 for the property. Mr. Glenn and the seller have agreed on a purchase price of $150,000. Shortly after the purchase is made by Mr. Glenn, he is offered $175,000 for the same property. At what price would Mr. Glenn record the property on the books of his business?

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Recognizing the Proprietor's Ownership

The proprietor in beginning a business contributes assets to the business. These assets contributed may consist of cash, supplies, or equipment. Each asset is assigned a money value based on the cost of the asset to the proprietor. Since the proprietor is also the owner of the business, those assets contributed represent the proprietor's ownership or equity in the business. A record is set up by the accountant to represent the proprietor's ownership in the business. This record is called CAPITAL.

CAPITAL is the ownership of the assets of the business by the proprietor. For every asset that the proprietor contributes to the business there is a corresponding value assigned to the record of proprietor's capital. A term frequently used interchangeably with capital is EQUITY. In this instance, equity represents the ownership of the assets of the business by the proprietor.

EXERCISE 8 Ms. Taylor began a business on April 1, 200-, contributing to the business the following assets: Cash, $3,000; Office Supplies, $275; Office Equipment, $700; Furniture and Fixtures, $2,100. Determine the value of Ms. Taylor's ownership (CAPITAL) in the business.

1. What is the total value of the assets that Ms. Taylor contributed to the business?
2. What is the value of Ms. Taylor's ownership in the business?

Assets = Capital

From the above relationship we can develop a simple equation which relates assets to capital. This equation will be expressed as: ASSETS = CAPITAL. Thus, if Ms. Taylor contributed to the business assets valued at $6,075, the equation would be expressed as:

ASSETS = CAPITAL
$6,075 = $6,075

If at some future date the proprietor contributes additional assets to the business, both the value of the total assets and the value of the capital will increase by the same amount, thus the equation would remain in balance. Should the proprietor decide to take an asset out of the business for personal use, this will cause a corresponding decrease in the value of the total assets and the value of the total capital.

EXERCISE 9 Using the chart presented below, show the effects on the equation caused by the following business transactions. After you have recorded the transactions on the chart, add the individual columns and verify that the equation is still in balance. (Remember that assets are set up in various categories depending upon the nature of the asset. If a business uses an existing asset to acquire another asset, this will only cause a change in assets. There will be no effect on the proprietor's capital. Transactions 4 and 5 should not affect capital; they represent an EXCHANGE OF ASSETS.)

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1. The proprietor invested $5,000 cash in the business.
2. The proprietor invested a typewriter valued at $250.
3. The proprietor took $200 out of the business as a permanent reduction in investment.
4. The proprietor purchased supplies for the business, paying for the supplies with $75 in cash from the business.
5. The proprietor purchased an adding machine for $50, paying with cash from the business.

ASSETS				=	CAPITAL
No.	CASH +	SUPPLIES +	EQUIPMENT	=	CAPITAL
1					
2					
3					
4					
5					
TOTAL					

EXERCISE 10

List the following headings on a sheet of paper. Cash + Accounts Receivable + Store Supplies + Office Supplies + Furniture and Fixtures + Equipment = Capital.

Record the following business transactions in the appropriate columns. Identify each by number and after each transaction is recorded, verify that the equation is in balance by FOOTING (adding) the columns. The proprietor of the business:

1. Invested $20,000 in the business.
2. Purchased furniture and fixtures for use in the business paying $1,200 in cash.
3. Purchased store supplies paying $170 in cash.
4. Purchased equipment for use in the business paying $1,500 in cash.
5. Loaned a business associate $750 in cash which he promised to repay in ten days.
6. Contributed office supplies to the business that had a value of $60.
7. Received a check for $300 in partial payment of the amount that his associate has owed him.
8. Permanently reduced his investment in the business by taking out a desk worth $100 and $900 in cash.
9. Returned equipment previously purchased and received a cash refund of $175.
10. Bought office supplies paying $65 in cash.

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Expressing Borrowed Assets

In the previous two exercises we practiced recording business transactions that affected assets and capital of the business. The owner of a sole proprietorship will use the assets he or she contributed to the business to acquire other assets that the business needs to function. In some circumstances there may be inadequate assets available to meet the needs of the business. When this situation occurs, it may be necessary for the business to obtain the needed assets from other sources.

The most obvious way in which additional assets can be obtained for the business is by borrowing. When cash or any other asset is borrowed, the firm is said to have incurred a debt or liability. Regardless of what is borrowed, it is customary to repay the obligation in cash. When the obligation is initially incurred, the business obtains the asset borrowed. At the same time, a liability is incurred which has to be recognized as an obligation of the business. Until the debt is paid, the creditor (the person to whom the money is owed) is said to have a claim upon the assets originally loaned. A LIABILITY is defined as the ownership of the assets of a business by its *creditors*. Notice that this definition of a liability is identical to the definition of capital, except for the last word. (Capital is the ownership of the assets of a business by the *proprietor*). Since a liability is, by definition, not an asset or ownership as evidenced by capital, it becomes necessary to establish a third classification of items, namely that of liabilities. Since a liability is closely associated with the ownership of the business assets, it is shown on the equation on the same side as capital. The term *equity* as previously discussed was used synonymously with *capital*. *Equity* signifies ownership, thus it represents both capital and liabilities in this case. The final form of the equation, which is generally known as the ACCOUNTING EQUATION, is:

ASSETS = LIABILITIES + CAPITAL

Liabilities may take many forms. If the owner of a business has to borrow money and orally promises to pay back the obligation, this obligation would be known as an ACCOUNT PAYABLE. If the promise made took the form of a written document, such as an IOU or a promissory note, then the obligation would be known as a NOTE PAYABLE. Regardless of the form that the actual obligation takes, its placement in the accounting equation would remain the same. Let's assume the following information:

ASSETS	=	LIABILITIES	+	CAPITAL
$14,000	=	–0–	+	$14,000

The business borrows $6,000 from a local bank. What would happen to the various classifications within the accounting equation? Show the new totals (balances) as a result of recording the transaction.

ASSETS	=	LIABILITIES	+	CAPITAL
$14,000	=	0	+	$14,000
+ $ 6,000	=	+ $6,000	+	0
$20,000	=	$6,000	+	$14,000

If at a later date the loan is repaid, determine the effects of the repayment on the total value of the assets, liabilities, and capital.

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EXERCISE 11

Calculate the value of the missing element of the accounting equation in each of the numbered situations:

	ASSETS	=	LIABILITIES	+	CAPITAL
1.	$6,000	=	$2,000	+	?
2.	$5,500	=	?	+	$2,300
3.	?	=	$4,500	+	$3,650
4.	$10,550	=	$485	+	?
5.	$8,400	=	?	+	$8,400

EXERCISE 12

A. L. Brandon is the owner of the Brandon Small Appliance Repair Shop. On January 1, 200-, the assets, liabilities, and proprietor's capital in the business were: Cash, $2,000; Accounts Receivable, $400; Supplies, $500; Equipment, $6,000; Accounts Payable, $900; A. L. Brandon, Capital, $8,000. The business transactions for the month of January were as follows:

1. Paid $300 of the outstanding accounts payable.
2. Received $100 on account (part payment) from customers.
3. Purchased $250 worth of supplies on account (on credit).
4. Returned a defective piece of equipment that was purchased last month and received a cash refund of $1,200.
5. Borrowed $1,000 from a supplier, giving word to repay the loan in thirty days.
6. Paid creditor $200 on account (part payment).
7. Purchased equipment for $800, giving $200 cash and promising to pay the balance in sixty days.
8. Bought supplies paying $65 cash.
9. Received a $250 check from customer on account.

Set up a chart using a form similar to that in Exercise 10. Record the January 1 balances immediately under the various assets, liability, and capital item headings. Record the business transactions listed above. Be certain to label each transaction with the corresponding number assigned, and foot the columns after each transaction has been recorded to verify the balance of the equation. Notice that every business transaction has a minimum of two changes. Transaction 7 has three changes, but notice that the dollar change is equal, thus the equation in this case, as with all the business transactions, remains in balance.

What Are Revenue, Expenses, and Profit?

Every business exists primarily to earn a profit. This profit is realized through REVENUE received by an organization as a result of the sale of a service or product by that business. Our primary concern will be with a business that provides a service. Examples of persons in service-oriented occupations are accountants, lawyers, doctors, beauticians, real estate and insurance brokers, and travel agents. The resulting profits

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of a service business belong to the owner (sole proprietor) of the enterprise. The revenue generated through the services provided are recognized as an increase in the capital of the owner. This is justified because the profits that the business earns belong to the owner of the business, and the revenue received should be reflected in the record of ownership.

RECORDING REVENUE

If revenue of $500 cash is received by the business, this revenue should be recorded as an increase in cash of $500 and a resulting increase in proprietor's capital of $500. Revenue may be received in forms other than cash. An organization may receive payment for services rendered in the form of other assets such as supplies, equipment, and even someone's word to pay at a future time (accounts receivable). The effects on the accounting equation will still result in an increase in the specific asset received and a corresponding increase in capital.

An increase in the proprietor's capital will result from not only an investment by the owner, but also as a result of revenue received for services provided.

RECORDING EXPENSES

Profit and revenue are not the same. PROFIT represents the income that a business has earned after certain adjustments have been made. Revenue is one component which permits the recognition of profit. Every business, regardless of its nature, must incur certain costs in order to operate. These costs are known as EXPENSES. Expenses are generally referred to as the "costs of doing business." Examples of expenses that businesses incur are rent expense, insurance expense, salary expense, and supplies expense. Expenses are also known as "necessary evils," because they must be incurred in order to obtain revenue which ultimately will be translated into profits for the business. While we learned that revenue causes an increase in capital, an expense will have the opposite effect and result in a decrease in capital.

If rent expense for the month amounting to $300 is paid, this will result in a decrease in the asset cash and a corresponding decrease in proprietor's capital.

A decrease in the proprietor's capital will result from a permanent reduction in the owner's investment in the business, from the proprietor taking assets out of the business, and now as a result of the payment of an expense.

Transaction	*Effect on Proprietor's Capital*
Owner's investment	Increase
Owner's withdrawals	Decrease
Revenues	Increase
Expenses	Decrease

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