

## Chapter 1

# Elements of Accounting

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**A**ccounting is a subject that requires you to learn concepts in a specific order. That's because concept B builds upon what you learned about concept A. In fact, an accounting student can get very frustrated trying to learn a concept by jumping ahead and not understanding earlier concepts. This chapter provides some of the critical elements of accounting. You need these concepts before moving on to any other accounting topics.

## *The Problems You'll Work On*

In this chapter, you see a variety of algebra problems:

- ✓ Working with transactions that change the accounting equation
- ✓ Defining assets, liabilities, equity, revenue, and expenses
- ✓ Understanding the differences between cash-basis and accrual-basis accounting
- ✓ Compiling the income statement using revenue and expense transactions
- ✓ Using the balance sheet and the income statement

## *What to Watch Out For*

Don't let common mistakes trip you up. Some of the following suggestions may be helpful:

- ✓ Be careful when using the accounting equation. There are two versions of the formula. One is  $\text{assets} - \text{liabilities} = \text{equity}$ . The other is  $\text{assets} = \text{liabilities} + \text{equity}$ . Keep in mind which version you're using.
- ✓ The profit calculation using accrual accounting is unrelated to a firm's cash position. A firm can have a very profitable month and have a very low cash position.
- ✓ To understand the statement of cash flows, identify the investment and financing transactions first. After you identify those transactions, all the other cash flows are related to operations.
- ✓ Accounts receivable and accounts payable transactions are only posted when you use accrual accounting. If a company is using the cash basis, you don't use receivables or payables.

## Types of Business Entities

1-5

1. Business entities can legally be organized in a variety of ways. What is a common characteristic among all business entity types?
2. What business type is a single-owner business?
3. Entering into a business with another person is an example of what type of business entity?
4. Why is a sole partnership not one of the ways of legally organizing a business?
5. Which business type is most difficult to create initially but, once created, makes it easier to raise funds and provides liability protection for the owners?

## The Accounting Equation and Why It Balances

6-30

6. What is the proper format of the basic accounting equation?
7. What are *assets*?
8. What makes a vehicle purchased with a loan an example of an asset?
9. What are *liabilities*?
10. Why is money owed to a bank on a loan considered a liability?
11. What does it mean when a company purchases something *on account*?
12. Why is a loan from a bank not an asset?

13. Why is office equipment an example of an asset?
14. What is the name for resources owned by a company?
15. A business has assets of \$135,000 and liabilities of \$45,000. Calculate the amount of owners' equity.
16. A business has liabilities of \$345,700 and owners' equity of \$154,300. Calculate the amount of assets the company has.
17. At the end of an accounting period, a company's total assets equaled \$1,450,000, and owners' equity was \$654,000. How much were the company's liabilities?
18. At the end of an accounting period, a company's total assets equaled \$576,000, and liabilities equaled \$245,000. How much was the company's owners' equity?
19. At the end of an accounting period, a company's owners' equity equaled \$2,376,000, and its liabilities equaled \$142,000. How much were the company's assets?
20. What does it mean when a business has *negative retained earnings*?
21. What is the effect on the accounting equation if a company buys a truck with a cash down payment of \$5,000 and borrows the remaining \$25,000?
22. What is the effect on the accounting equation when a company pays cash for purchases of inventory?
23. What is the effect on the accounting equation when a company obtains a loan to purchase a delivery truck?
24. A company owes a supplier \$37,000 for inventory purchased a week ago. What is the effect on the accounting equation if the company makes a \$20,000 payment?

25. What is the effect on the accounting equation when owners contribute a delivery truck to a company?
26. What is the effect on the accounting equation when a company earns revenue by selling a product and collects the amount of the sale in cash?
27. What is the impact on the accounting equation when a company uses its cash to pay for office expenses such as rent and utilities?
28. What does it mean when a business is *highly leveraged*?
29. The owners of a start-up invest \$1,000,000 into the business. After one year of operations, the business has assets of \$850,000 and losses of \$300,000. What are the total liabilities at the end of the first year?
30. The owners of a start-up invest \$50,000 into the business. After one year of operations, the business has assets of \$350,000 and liabilities of \$200,000. How much profit or loss did the business generate during the first year?

## Cash-basis Accounting versus Accrual-basis Accounting

31–52

31. What is the main characteristic of cash-basis accounting?
32. What is the main characteristic of accrual-basis accounting?
33. What is the primary difference between cash-basis and accrual-basis accounting?
34. Cash-basis accounting is most frequently used by which group?
35. Accrual-basis accounting is most frequently used by which group?
36. Why is cash-basis accounting *not* used by large businesses?

- 37.** When are transactions recorded under accrual-basis accounting?
- 38.** Al LaMode Ice Cream Company produces high-quality ice cream that is distributed to shops in resort areas. On July 1, the company purchased the raw materials to make the ice cream. On July 15, the process was complete, and the product was stored in the freezer ready to ship to customers. On July 31, Ken and Mary's Ice Cream Shop ordered 200 pounds of ice cream. On August 1, Al LaMode delivered the ice cream to Ken and Mary's Ice Cream Shop. Ken and Mary paid Al LaMode on August 10. Ken and Mary sold all the ice cream between August 5 and August 12. If it uses accrual-basis accounting, when will Al LaMode record the revenue from the sale to Ken and Mary?
- 39.** Al LaMode Ice Cream Company produces high quality ice cream that is distributed to shops in resort areas. On July 1, the company purchased the raw materials to make the ice cream. On July 15, the process was complete, and the product was stored in the freezer ready to ship to customers. On July 31, Ken and Mary's Ice Cream Shop ordered 200 pounds of ice cream. On August 1, Al LaMode delivered the ice cream to Ken and Mary's Ice Cream Shop. Ken and Mary paid Al LaMode on August 10. Ken and Mary sold all the ice cream between August 5 and August 12. If it uses cash-basis accounting, when will Al LaMode record the revenue from the sale to Ken and Mary?
- 40.** Little Falls Bandages sells medical supplies to college football teams. The teams pay a flat fee of \$10,000 on August 1 for as many bandages as they need during the football season, September through November. If they use cash-basis accounting, how much revenue does Little Falls record in September?
- 41.** Furd Buggy Company uses electricity in its retail shop during the month of May. On June 15, the company receives the bill for the May electricity usage for \$759. Furd pays the bill on July 1. If Furd Buggy Company uses accrual-basis accounting, on which month's income statement will the expense appear, and how much will it be?
- 42.** Credit Cab Corporation buys fuel from a fuel bank, paying \$1,000,000 on January 1 for 250,000 gallons of fuel. The company uses the last of the 250,000 gallons on July 1. The January income statement shows a fuel expense of \$1,000,000. What basis of accounting does Credit Cab use?

**43–49** Use the following information to answer the questions. The following is selected information regarding Ace, Inc. for the fiscal year 2015:

- ✓ Cash receipts from sales made in 2015: \$750,000
- ✓ Cash payments for purchases of inventory in 2015: \$325,000
- ✓ The company did not have a beginning inventory balance in 2015.
- ✓ Cash payments for other expenses: \$375,000
- ✓ Year-end receivables balance from customers for sales made during the year 2015: \$155,000
- ✓ Cost of products in ending inventory that have not been sold: \$120,000
- ✓ Liability for unpaid expenses that were incurred in 2015: \$450,000

**43.** Calculate the amount of cash-basis revenues for Ace, Inc. for 2015.

**44.** Calculate the amount of cash-basis expenses for Ace, Inc. for 2015.

**45.** Calculate the amount of cash-basis profit or loss for Ace, Inc. for 2015.

**46.** Calculate the amount of accrual-basis revenues for Ace, Inc. for 2015.

**47.** Calculate the accrual-basis cost of goods sold for Ace, Inc. for 2015.

**48.** Calculate, using the accrual basis, other expenses for Ace, Inc. for 2015.

**49.** Calculate the accrual-basis profit or loss for Ace, Inc. for 2015.

**50–52** Use the following information to answer the questions. XYZ, Inc. had the following transactions during 2015:

- ✓ Sales on account: \$5,000
- ✓ Cash sales: \$6,000
- ✓ Amount collected as customer deposits in 2016: \$3,000
- ✓ Amount paid for utilities expenses incurred in 2015: \$2,000
- ✓ Amount paid in advance for services to be used in 2016: \$1,000

50. Calculate the amount of cash-basis revenues for XYZ, Inc. for 2015.
51. Calculate the amount of cash-basis expenses for XYZ, Inc. for 2015.
52. Calculate the amount of difference between accrual-basis revenues and cash-basis revenues for XYZ, Inc. for 2015.
55. What is the financial statement that shows the business profit or loss during a period?
56. The financial statement you are looking at lists revenues and gains, along with some other items. What financial statement are you viewing?
57. Other than revenues and expenses, what other items may be found on an income statement?

### *Profit Activities and the Income Statement*

53–72

53. What is the name of the financial statement that summarizes a company's revenues, other income, expenses, and losses?
54. What is another name for an income statement?
58. A banker asks a borrower for information on the company's revenue growth over the last few years. What financial statement will the borrower provide the banker?
59. What information is presented on an income statement?

- 60.** Which of the following items appear on an income statement?
- A. deferred revenue
  - B. current liabilities
  - C. loss on the sale of equipment
  - D. cash received from customers
  - E. dividends paid to stockholders

- 61.** Identify the expenses that must be listed separately on the income statement to comply with accounting rules.

**62–64** Use the following information to answer the questions. Hummus Records has the following current-year information in its accounting records:

- ✓ Sales revenue: \$47,000
- ✓ Interest revenue: \$1,200
- ✓ Selling expenses: \$14,000
- ✓ General expenses: \$3,000
- ✓ Cost of goods sold: \$20,000
- ✓ Tax expense: \$2,200

- 62.** Calculate the gross profit for Hummus Records.

- 63.** Calculate the operating income for Hummus Records.

- 64.** Calculate the income before taxes for Hummus Records.

**65–68** Use the following information to answer the questions. The following data is available for Koala Kuddles for 2015:

- ✓ Sales revenue: \$15,000,000
- ✓ Cost of goods sold: \$12,400,000
- ✓ Interest expense: \$125,000
- ✓ Selling, general, and administrative expense: \$1,450,000
- ✓ Loss on the sale of equipment: \$275,000
- ✓ Income tax expense: \$200,000
- ✓ Cost of new equipment: \$800,000

- 65.** What is the amount of gross profit on Koala Kuddles' 2015 income statement?

- 66.** What is the amount of operating earnings on Koala Kuddles' 2015 income statement?

- 67.** What is the amount of earnings or loss before income taxes on Koala Kuddles' 2015 income statement?

68. What is the amount of net income or loss on Koala Kuddles' 2015 income statement?

**69–72** Use the following information to answer the questions. The following data is available for Petal Bikes for 2015:

- ✓ Sales revenue: \$8,000,000
- ✓ Gross margin: \$2,000,000
- ✓ Operating earnings: \$650,000
- ✓ Earnings before income tax: \$420,000
- ✓ Net income: \$180,000
- ✓ Petal Bikes had no gains or losses and no interest revenue in 2015.

69. What is the amount of income tax expense on Petal Bikes' 2015 income statement?

70. What is the amount of the cost of goods sold on Petal Bikes' 2015 income statement?

71. What is the amount of selling, general, and administrative expenses on Petal Bikes' income statement?

72. What is the amount of interest expense on Petal Bikes' 2015 income statement?

## Financial Condition and the Balance Sheet

**73–78**

73. What are the three primary financial statements?

74. What is the balance sheet sometimes called?

75. GameTime Caterers has presented its banker with a financial statement that displays the cash balance on hand, the amount owed to its suppliers, common stock, and retained earnings as of December 31, 2015. What statement did the company give to the banker?

**76–78** Use the following information to answer the questions. The following data is available for Car Bop, Inc. for 2015:

- ✓ Amounts owed by customers: \$75,000
- ✓ Cost of unsold product: \$90,000
- ✓ Cash balance: \$110,000
- ✓ Amounts owed for unpaid purchases and expenses: \$72,000
- ✓ Notes payable to bank: \$73,000
- ✓ Unearned revenues: \$10,000
- ✓ Cash sales for 2015: \$227,000
- ✓ Credit sales for 2015: \$133,000
- ✓ Cost of goods sold for 2015: \$175,000

- 76.** What are the total assets on Car Bop's balance sheet?
- 77.** What are the total liabilities on Car Bop's balance sheet?
- 78.** What is the total equity on Car Bop's balance sheet?

## Cash Flows and the Statement of Cash Flows

**79–90**

- 79.** A banker is considering a loan to finance a vehicle for a small company but wants to make sure that the company will have enough cash to make the payments over the next three years. What statement should she look at?
- 80.** The statement of cash flows includes a section called which of the following?
- A. cash outflows
  - B. cash inflows
  - C. summary of cash
  - D. operating activities
  - E. spending activities
- 81.** During the year, Organic Bricks Co. paid cash for a new delivery truck. Where on the statement of cash flows would that event appear?
- 82.** During the year, Organic Bricks made the last payment on the mortgage on its building. How should the company classify this on the statement of cash flows?

- 83.** Organic Bricks sold an old truck that originally cost \$76,000. The book value of the truck was \$26,000, and the company received \$30,000 in cash from the buyer as full payment. How should the company reflect this transaction in the cash flows from investing activities?
- 84.** Determine the amount of change in cash during the year based on the following:
- ✓ Cash flow from operating activities: (\$50,000)
  - ✓ Cash flow from investing activities: \$20,000
  - ✓ Cash flow from financing activities: \$50,000
  - ✓ Significant non-cash transactions include purchase of a building with a \$250,000 note.
- 85.** Determine the cash flow from investing activities during the year based on the following:
- ✓ Cash flow from operating activities: \$50,000
  - ✓ Cash flow from financing activities: \$25,000
  - ✓ Net increase/(decrease) in cash during the year: (\$40,000)
- 86.** Determine the cash flow from financing activities during the year based on the following:
- ✓ Cash flow from operating activities: \$6,000
  - ✓ Cash flow from investing activities: (\$5,000)
  - ✓ Net increase/(decrease) in cash during the year: \$13,000
- 87.** Determine the cash flow from operating activities during the year based on the following:
- ✓ Cash flow from investing activities: \$45,000
  - ✓ Cash flow from financing activities: (\$55,000)
  - ✓ Cash at the beginning of the year: \$270,000
  - ✓ Cash at the end of the year: \$370,000

**88–90** Use the following information to answer the questions. The following data is available for Lawn Paint Yard Service:

- ✓ Proceeds received from issuance of stock: \$20,000
- ✓ New equipment purchases: \$130,000
- ✓ Amount of a new note payable: \$65,000
- ✓ Proceeds from sale of old equipment with a book value of \$40,000: \$45,000
- ✓ Dividends paid: \$40,000
- ✓ Dividends declared but unpaid: \$10,000
- ✓ Cash flow from operating activities: \$45,000

**88.** Calculate the cash flow from investing activities for Lawn Paint Yard Service.

**89.** Calculate the cash flow from financing activities for Lawn Paint Yard Service.

**90.** If Lawn Paint Yard Service started the year with a cash balance of \$6,300, what was the balance of cash on hand at the end of the year?