

# Chapter 1

# ACCOUNTING IN ACTION

<i>The Navigator</i> ✓	
■ Scan Study Objectives	<input type="checkbox"/>
■ Read Preview	<input type="checkbox"/>
■ Read Chapter Review	<input type="checkbox"/>
■ Work Demonstration Problem	<input type="checkbox"/>
■ Answer True-False Statements	<input type="checkbox"/>
■ Answer Multiple-Choice Questions	<input type="checkbox"/>
■ Match Terms and Definitions	<input type="checkbox"/>
■ Solve Exercises	<input type="checkbox"/>

## CHAPTER LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Explain what accounting is.
2. Identify the users and uses of accounting.
3. Understand why ethics is a fundamental business concept.
4. Explain generally accepted accounting principles.
5. Explain the monetary unit assumption and the economic entity assumption.
6. State the accounting equation and define its components.
7. Analyze the effect of business transactions on the accounting equation.
8. Understand the four financial statements and how they are prepared.
- \*9. Explain the career opportunities in accounting.
- \*10. Describe the impact of international accounting standards on U.S. financial reporting.

\*Note: All asterisked (\*) items relate to material contained in the Appendix to the chapter.

## PREVIEW OF CHAPTER 1

The purpose of this chapter is to show you that accounting is the system used to provide useful financial information. The content and organization of the chapter are as follows:

ACCOUNTING IN ACTION				
What Is Accounting?	The Building Blocks of Accounting	The Basic Accounting Equation	Using the Accounting Equation	Financial Statements
<ul style="list-style-type: none"> <li>• Three activities</li> <li>• Who uses accounting data</li> </ul>	<ul style="list-style-type: none"> <li>• Ethics in financial reporting</li> <li>• Generally accepted accounting principles</li> <li>• Measurement principles</li> <li>• Assumptions</li> </ul>	<ul style="list-style-type: none"> <li>• Assets</li> <li>• Liabilities</li> <li>• Owner's equity</li> </ul>	<ul style="list-style-type: none"> <li>• Transaction analysis</li> <li>• Summary of transactions</li> </ul>	<ul style="list-style-type: none"> <li>• Income statement</li> <li>• Owner's equity statement</li> <li>• Balance sheet</li> <li>• Statement of cash flows</li> </ul>



## CHAPTER REVIEW

### Accounting Defined

1. (L.O. 1) **Accounting** is an information system that identifies, records, and communicates the economic events of an organization to interested users.
  - a. The first part of the process, **identifying**, involves selecting those events that are considered evidence of economic activity relevant to a particular business organization.
  - b. **Recording** is the keeping of a chronological diary of events, measured in dollars and cents.
  - c. **Communication** occurs through the preparation and distribution of accounting reports.
2. The accounting process consists of:  
Identification → Recording → Communication.
3. (L.O. 2) **Internal users** of accounting information are managers who plan, organize, and run a business. These include marketing managers, production supervisors, finance directors, and company officers.
4. **External users** include investors, creditors, taxing authorities, regulatory agencies, labor unions, customers, and economic planners outside the business.

### Ethics

5. (L.O. 3) The standards of conduct by which one's actions are judged as right or wrong, honest or dishonest, fair or not fair, are **ethics**. The process of analyzing ethical issues is to recognize that an ethical issue is involved, identify and analyze the principle elements in the situation (especially those harmed or benefited), identify the alternatives and weigh the impact of each alternative on the various stakeholders, then select the most ethical alternative.

### GAAP and the Cost Principle

6. (L.O. 4) **Generally accepted accounting principles** (GAAP) are a common set of guidelines (standards) used by accountants in reporting economic events.
7. The **Securities and Exchange Commission** (SEC) is an independent regulatory agency of the United States government. The SEC has the legal power to enforce the form and content of financial statements of corporations that wish to sell securities to the public.
8. The **Financial Accounting Standards Board** (FASB) has been granted the power from the SEC to establish GAAP. Currently the U.S. is converging to International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB). At the end of each chapter there will be a section addressing IFRS.

---

### The Monetary Unit and Economic Entity Assumptions

9. (L.O. 5) The accounting profession has developed certain assumptions that serve as guidelines for the accounting process.
  - a. The **monetary unit assumption** requires that only transaction data that can be expressed in terms of money be included in the accounting records.
  - b. The **economic entity assumption** requires that the activities of the entity be kept separate and distinct from (1) the activities of its owner and (2) all other economic entities.
10. GAAP generally uses one of two measurement principles, the **historical cost principle** or the **fair value principle**.
11. Under the **historical cost principle** (or cost principle) assets should be recorded at their cost. Cost is the value exchanged at the time something is acquired.
12. The **fair value principle** states that assets and liabilities should be reported at fair value (the price received to sell an asset or settle a liability). This information may be important for certain investment securities.

### Business Enterprises

13. Three types of business enterprises are proprietorships, partnerships, and corporations.
  - a. A **proprietorship** is a business owned by one person.
  - b. A **partnership** is a business owned by two or more persons associated as partners.
  - c. A **corporation** is a business organized as a separate legal entity under state corporation law with ownership divided into transferable shares of stock.

### The Accounting Equation

14. (L.O. 6) The **basic accounting equation** is:

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

The accounting equation applies to all economic entities regardless of size, nature of business, or form of business organization.

15. The key components of the basic accounting equation are:
  - a. **Assets** are resources owned.
  - b. **Liabilities** are claims against assets.
  - c. **Owner's equity** is the claims of owners.
16. In proprietorships, there are four **subdivisions** of owner's equity:
  - a. **Investments by Owner** are the assets put in the business by the owner.
  - b. **Revenues** are the gross increases in owner's equity resulting from business activities entered into for the purpose of earning income.
  - c. **Drawings** are withdrawals of cash or other assets by the owner for personal use.
  - d. **Expenses** are the cost of assets consumed or services used in the process of earning revenue.

17. The **expanded accounting equation** is:  
$$\text{Assets} = \text{Liabilities} + \text{Owner's Capital} - \text{Owner's Drawings} + \text{Revenues} - \text{Expenses}$$

### Transactions

18. (L.O. 7) **Transactions** are the economic events of the enterprise recorded. Transactions may be identified as either external or internal transactions.
19. Each transaction must be analyzed in terms of its effect on the components of the basic accounting equation. The analysis must also identify the specific items affected and the amount of the change in each item.
20. Each transaction has a dual effect on the equation. For example, if an individual asset is increased, there must be a corresponding:
- decrease in another asset, or
  - increase in a specific liability, or
  - increase in owner's equity.
21. A tabular summary may be prepared to show the cumulative effect of transactions on the basic accounting equation. The summary demonstrates that:
- Each transaction must be analyzed in terms of its effect on (1) the three components of the equation and (2) specific types of items within each component.
  - The two sides of the equation must always be equal.
  - The causes of each change in the owner's claim on assets must be indicated in the owners' equity column.

### The Financial Statements

22. (L.O. 8) Four financial statements are prepared from the summarized accounting data:
- An **income statement** presents the revenues and expenses and resulting net income (or net loss) of a company for a specific period of time.
  - An **owner's equity statement** summarizes the changes in owner's equity for a specific period of time.
  - A **balance sheet** reports the assets, liabilities, and owner's equity at a specific date.
  - A **statement of cash flows** summarizes information concerning the cash inflows (receipts) and outflows (payments) for a specific period of time.
23. The financial statements are **interrelated** because:
- Net income (or net loss) shown on the income statement is added (subtracted) to (from) the beginning balance of owner's capital in the owner's equity statement.
  - Owner's capital at the end of the reporting period shown in the owner's equity statement is reported in the balance sheet.
  - The amount of cash shown on the balance sheet is reported on the statement of cash flows.
24. In the income statement, revenues are listed first, followed by expenses. Then below expenses is the resulting amount of net income (or net loss).
25. The owner's equity statement shows the owner's capital at the beginning of the period, additional investments, net income (or net loss) for the period, owner's drawings, and the owner's capital at the end of the period.
26. In the balance sheet, assets are listed at the top, followed by liabilities and owner's equity.

27. The statement of cash flows reports the sources, uses, and net increase or decrease in cash. Chapter 18 will examine in detail how the statement is prepared.

### **\*Careers in Accounting**

- \*28. (L.O. 9) **Public accounting** provides the services of auditing, taxation, and management consulting.
- Auditing** involves examining financial statements of companies and expressing an opinion as to the fairness of their presentation.
  - Taxation** includes providing tax advice and planning, preparing tax returns, and representing clients before governmental agencies.
  - Management consulting** involves providing advice for managers on such matters as financial planning and control and the development of computer systems.
- \*29. **Private accounting** involves the employment of accountants within individual companies. The private accountant performs a wide variety of duties such as general accounting, cost accounting, budgeting, accounting information systems, tax accounting, and internal auditing.
- \*30. **Government accounting** is another option available such as employment with the Internal Revenue Service (IRS), Federal Bureau of Investigation (FBI) and the Securities and Exchange Commission (SEC).
- \*31. **Forensic accounting** uses accounting, auditing, and investigative skills to conduct investigations into theft and fraud.

### **A Look at IFRS**

- \*32. (L.O. 10) The reasons we need one set of international accounting standards are:
- **Multinational corporations.**
  - **Mergers and acquisitions.**
  - **Information technology.**
  - **Financial markets.**
- \*33. International standards are referred to as International Financial Reporting Standards (IFRS), developed by the International Accounting Standards Board (IASB). Over 115 countries require or permit use of IFRS.
- \*34. Many of the differences between generally accepted accounting principles (GAAP) and IFRS are a result of responding to different user needs.
- \*35. There are continuing debates on the application of Sarbanes – Oxley (SOX) type standards to non-U.S. companies. Another debate centers on whether standards should be “principle-based” (applicable more so for current international standards) or “rules-based” (applicable more so for current GAAP).



**DEMONSTRATION PROBLEM (L.O. 8)**

Prepare a balance sheet for the Morse Soybean Company on December 31, 2014, using the following list of accounts.

Accounts Payable .....	\$4,000
Accounts Receivable .....	3,500
Cash .....	6,000
Equipment .....	7,000
Notes Payable .....	6,500
J. J. Morse, Capital .....	?
Salaries Payable .....	2,000
Supplies .....	2,500
Automobile .....	4,500



**SOLUTION TO DEMONSTRATION PROBLEM**

**MORSE SOYBEAN COMPANY  
Balance Sheet  
December 31, 2014**

**Assets**

Cash .....	\$ 6,000
Accounts Receivable .....	3,500
Supplies .....	2,500
Equipment .....	7,000
Automobile .....	4,500
Total assets .....	<u>\$23,500</u>

**Liabilities and Owner's Equity**

<b>Liabilities</b>	
Accounts Payable .....	\$ 4,000
Salaries Payable .....	2,000
Notes Payable .....	6,500
Total liabilities .....	<u>12,500</u>
<b>Owner's Equity</b>	
J.J. Morse, Capital .....	<u>11,000</u>
Total liabilities and owner's equity .....	<u>\$23,500</u>

---

## REVIEW QUESTIONS AND EXERCISES

### TRUE—FALSE

Indicate whether each of the following is true (T) or false (F) in the space provided.

- \_\_\_\_\_ 1. (L.O. 1) Accounting provides the principal medium for communicating financial information of a business to all interested parties.
- \_\_\_\_\_ 2. (L.O. 1) Identifying is the process of keeping a chronological diary of events measured in dollars and cents.
- \_\_\_\_\_ 3. (L.O. 2) Customers and regulatory agencies are external users of accounting data.
- \_\_\_\_\_ 4. (L.O. 2) Internal users of accounting information are managers, production supervisors, and finance directors.
- \_\_\_\_\_ 5. (L.O. 3) Accountants do **not** have to worry about issues of ethics.
- \_\_\_\_\_ 6. (L.O. 4) GAAP is an acronym for "governmentally approved accounting principles."
- \_\_\_\_\_ 7. (L.O. 4) The FASB has been granted the power from the SEC to establish GAAP.
- \_\_\_\_\_ 8. (L.O. 5) Under the economic entity assumption, it is assumed that the company is separate and distinct from its owner(s).
- \_\_\_\_\_ 9. (L.O. 5) The monetary unit assumption requires that all dollar amounts be rounded to the nearest dollar.
- \_\_\_\_\_ 10. (L.O. 4) At the time an asset is acquired, cost and value should be the same.
- \_\_\_\_\_ 11. (L.O. 5) Proprietors are liable only for the amount they have invested in the business.
- \_\_\_\_\_ 12. (L.O. 6) An asset may be intangible and represent nonphysical rights.
- \_\_\_\_\_ 13. (L.O. 6) Owner's equity is the ownership claim on total assets.
- \_\_\_\_\_ 14. (L.O. 6) Expenses are the decreases in owner's equity that result from operating the business.
- \_\_\_\_\_ 15. (L.O. 6) If a liability increases, there would either have to be an equal decrease in another liability, a decrease in an asset, or an increase in owner's equity for the basic accounting equation to remain equal.
- \_\_\_\_\_ 16. (L.O. 6) The basic accounting equation is in balance when the creditor and ownership claims against the business equal the assets.
- \_\_\_\_\_ 17. (L.O. 7) External transactions involve economic events between the company and some other enterprise or party.
- \_\_\_\_\_ 18. (L.O. 8) In the owner's equity statement, revenues are listed first, followed by expenses, and net income (or net loss).

- \_\_\_\_\_ 19. (L.O. 8) The balance sheet is often referred to as the operating statement.
- \_\_\_\_\_ 20. (L.O. 9) Management consulting includes examining the financial statements of companies and expressing an opinion as to the fairness of their presentation.



## MULTIPLE CHOICE

Circle the letter that best answers each of the following statements.

1. (L.O. 1) Which of the following is **not** part of the accounting process?
  - a. Recording.
  - b. Identifying.
  - c. Financial decision making.
  - d. Communicating.
  
2. (L.O. 2) Internal users of accounting data include:
  - a. economic planners.
  - b. investors.
  - c. customers.
  - d. company officers.
  
3. (L.O. 4) The organization(s) primarily responsible for establishing generally accepted accounting principles is(are) the:

<b>FASB</b>	<b>SEC</b>
a. no	no
b. yes	no
c. no	yes
d. yes	yes
  
4. (L.O. 5) The monetary unit assumption:
  - a. provides that the unit of measure fluctuates over time.
  - b. is unimportant in applying the cost principle.
  - c. is only used for financial statements of banks.
  - d. requires that only transaction data capable of being expressed in terms of money be included in the accounting records of the economic entity.
  
5. (L.O. 5) A proprietorship is a business:
  - a. owned by one person.
  - b. owned by two or more persons.
  - c. organized as a separate legal entity under state corporation law.
  - d. owned by a governmental agency.



- 
6. (L.O. 6) A net loss will result during a time period when:
    - a. assets exceed liabilities.
    - b. assets exceed owner's equity.
    - c. expenses exceed revenues.
    - d. revenues exceed expenses.
  
  7. (L.O. 7) A company might carry on many activities that do **not** represent business transactions such as:
    - a. borrowing money from the bank.
    - b. placing an order for merchandise with a supplier.
    - c. using office supplies.
    - d. paying wages.
  
  8. (L.O. 7) An example of an internal transaction is the:
    - a. payment of monthly rent.
    - b. hiring of employees.
    - c. sale of pizza puffs to customers.
    - d. use of paper, pens, and other office supplies.
  
  9. (L.O. 7) The Relias Uptown Grill receives a bill of \$400 from the Erml Advertising Agency. The owner, John Relias, is postponing payment of the bill until a later date. The effect on specific items in the basic accounting equation is:
    - a. a decrease in Cash and an increase in Accounts Payable.
    - b. a decrease in Cash and an increase in J. Relias, Capital.
    - c. an increase in Accounts Payable and a decrease in J. Relias, Capital.
    - d. a decrease in Accounts Payable and an increase in J. Relias, Capital.
  
  10. (L.O. 7) The Nagy Company is owned by Lynn Nagy. Jim James, the inventory clerk, indicates that \$975 of supplies were used during the period. The effect on specific items in the basic accounting equation is:
    - a. a decrease in Supplies and a decrease in L. Nagy, Capital.
    - b. a decrease in Cash and an increase in Supplies.
    - c. an increase in Accounts Payable and a decrease in Supplies.
    - d. an increase in Supplies Payable and a decrease in L. Nagy, Capital.
  
  11. (L.O. 7) Doug Foerch, owner of the Poindexter Company, withdraws \$500 in cash for personal use. The effect on the specific items in the basic accounting equation is:
    - a. an increase in Accounts Receivable and a decrease in Doug Foerch, Capital.
    - b. an increase in Salary Expense and a decrease in Cash.
    - c. an increase in Doug Foerch, Capital and a decrease in Cash.
    - d. a decrease in Doug Foerch, Capital and a decrease in Cash.
  
  12. (L.O. 7) Jeanie Company purchases \$600 of equipment from Mundelein Inc. for cash. The effect on the components of the basic accounting equation of Jeanie Company is:
    - a. an increase in assets and liabilities.
    - b. a decrease in assets and liabilities.
    - c. no change in total assets.
    - d. an increase in assets and a decrease in liabilities.

13. (L.O. 7) The Vessely Company has the following at September 17: assets \$13,000; liabilities \$8,000; and owner's equity \$5,000. On September 18, Vessely Company receives \$500 of cash revenue and earns \$200 of revenue on credit. Mike McEllen, the only worker that day, works 8 hours and receives a wage rate of \$10 per hour. Mike will not get paid until September 21. No other transactions occur during the day. At the end of September 18 the new totals are:

	<u>Assets</u>	<u>Liabilities</u>	<u>Owner's Equity</u>
a.	\$13,500	\$7,880	\$5,620
b.	\$12,500	\$8,000	\$4,500
c.	\$13,500	\$8,120	\$5,380
d.	\$13,700	\$8,080	\$5,620

14. (L.O. 7) As of December 31, 2014, Morley Company has liabilities of \$5,000 and owner's equity of \$7,000. It earned revenues of \$23,000 during the year ended December 31, 2014. What are the assets for Morley Company as of December 31, 2014?
- \$2,000.
  - \$12,000.
  - \$25,000.
  - \$35,000.
15. (L.O. 8) The statement that reports revenues and expenses is the:
- income statement.
  - balance sheet.
  - owner's equity statement.
  - statement of cash flows.
16. (L.O. 8) Morreale Beaver Company buys a \$12,000 van on credit. The transaction will affect the:
- income statement only.
  - balance sheet only.
  - income statement and owner's equity statement only.
  - income statement, owner's equity statement, and balance sheet.
17. (L.O. 8) The financial statement that summarizes the financial position of a company is the:
- income statement.
  - balance sheet.
  - operating statement.
  - owner's equity statement.
18. (L.O. 8) Which of the following would **not** appear on the DeFlippo Company's balance sheet?
- Accounts receivable.
  - M. DeFlippo, Capital.
  - Utilities expense.
  - Wages payable.

- 
- \*19. (L.O. 9) Auditing is:
- the examination of financial statements by a CPA in order to express an opinion on their fairness.
  - a part of accounting that involves only recording of economic events.
  - an area of accounting that involves such activities as cost accounting, budgeting, and accounting information systems.
  - conducted by the Securities and Exchange Commission to ensure that registered financial statements are presented fairly.
- \*20. (L.O. 9) The private accountant might be involved in:
- internal auditing.
  - tax accounting.
  - designing accounting and total information systems.
  - all of these answer choices are correct.



**MATCHING**

Match each term with its definition by writing the appropriate letter in the space provided.

<b>Terms</b>	<b>Definitions</b>
_____ 1. Revenues.	a. Economic events of the enterprise recorded by accountants.
_____ 2. Owner's equity statement.	b. An information system that identifies, records, and communicates the economic information of an organization to interested users.
_____ 3. Owner's equity.	c. The gross increases in owner's equity resulting from business activities entered into for the purpose of earning income.
_____ 4. Balance sheet.	d. Resources owned by the business.
_____ 5. Monetary unit assumption.	e. Reports the assets, liabilities, and owner's equity of a business enterprise at a specific date.
_____ 6. Income statement.	f. Presents the revenues and expenses and resulting net income of a company for a specific period of time.
_____ 7. Economic entity assumption.	g. Cost of assets consumed or services used in the process of earning revenue.
_____ 8. Assets.	h. Creditorship claims on total assets.
_____ 9. Accounting.	i. Ownership claim on total assets.
_____ 10. Transactions.	j. Summarizes the changes in owner's equity for a specific period of time.
_____ 11. Expenses.	k. Requires that only transaction data capable of being expressed in terms of money be included in the accounting records.
_____ 12. Liabilities.	l. States that sometimes assets and liabilities should be reported at fair value.
_____ 13. Generally accepted accounting principles.	m. States that assets should be recorded at their cost.
_____ 14. Historical cost principle.	n. A common set of rules, procedures, and guidelines (standards) used by accountants in reporting economic events.
_____ 15. Fair value principle.	o. States that the activities of the entity be kept separate and distinct from the activities of its owner and all other economic activities.



**EXERCISES**

**EX. 1-1** (L.O. 8) Some amounts are omitted in each of the following financial statements.

**INCOME STATEMENT**  
For the Year Ended December 31, 2014

	<b>Tang Company</b>	<b>June Company</b>	<b>Diana Company</b>
Revenues	\$48,000	\$ (D)	\$82,000
Expenses	(A)	52,000	64,000

**OWNER'S EQUITY STATEMENT**  
For the Year Ended December 31, 2014

	<b>Tang Company</b>	<b>June Company</b>	<b>Diana Company</b>
Capital, January 1	\$ (B)	\$45,000	\$50,000
Net income	15,000	24,000	(G)
Drawings	12,000	(E)	17,000
Capital, December 31	33,000	54,000	(H)

**BALANCE SHEET**  
December 31, 2014

	<b>Tang Company</b>	<b>June Company</b>	<b>Diana Company</b>
Total assets	\$75,000	\$ (F)	\$91,000
Total liabilities	(C)	56,000	40,000
Total owner's equity	33,000	54,000	(I)

**Instructions**

Determine the missing amounts and indicate your answers in the spaces provided below.

(A) _____	(D) _____	(G) _____
(B) _____	(E) _____	(H) _____
(C) _____	(F) _____	(I) _____

**EX. 1-2** (L.O. 7) On March 1, Laurie Fiala opened the Wahoo Beauty Salon. During the first month, the following selected transactions occurred.

1. Deposited \$5,000 cash in the City Bank in the name of the business.
2. Paid \$800 cash for beauty supplies.
3. Purchased equipment at a cost of \$12,000, paying \$2,000 in cash and the balance on account.
4. Received \$1,200 cash for services rendered.
5. Paid \$500 cash as a salary to a beautician.
6. Withdrew \$400 cash for personal expenses.

**Instructions**

Prepare a tabular summary of the transactions, using the following column headings: Cash, Supplies, Equipment, Accounts Payable, and L. Fiala, Capital.

Trans- action	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	L. Fiala Capital
1.									
2.									
3.									
4.									
5.									
6.									

**EX. 1-3** (L.O. 8) Selected financial statement items for the Geimer Company are presented below.

- |                               |                                |
|-------------------------------|--------------------------------|
| a. Accounts payable           | g. B. Geimer, Capital 12/31/14 |
| b. Service revenue            | h. Land                        |
| c. B. Geimer, Capital, 1/1/14 | i. Utilities expense           |
| d. Rent expense               | j. B. Geimer, Drawing          |
| e. Supplies                   | k. Net income                  |
| f. Advertising expense        | l. Salaries payable            |

**Instructions**

Indicate the financial statement(s) in which each item should be reported using the following code number(s): (1) Income statement for the year ended December 31, 2014, (2) Owner's equity statement for the year ended December 31, 2014, and (3) Balance sheet, December 31, 2014.

**(Note:** More than one code number may be required for an item.)

Item	Financial Statement	Item	Financial Statement	Item	Financial Statement
a.		e.		i.	
b.		f.		j.	
c.		g.		k.	
d.		h.		l.	



## SOLUTIONS TO REVIEW QUESTIONS AND EXERCISES

### TRUE-FALSE

1. (T)
2. (F) **Identifying** is selecting those events that are considered evidence of economic activity relevant to a particular business organization. The process of keeping a chronological diary of events measured in dollars and cents is **recording**.
3. (T)
4. (T)
5. (F) Accountants have to worry about ethical issues just like everybody else.
6. (F) GAAP is an acronym for "generally accepted accounting principles."
7. (T)
8. (T)
9. (F) The monetary unit assumption requires that only transaction data capable of being expressed in terms of money be included in the accounting records of the economic entity.
10. (T)
11. (F) A proprietor has unlimited liability for the debts incurred by the business. The stockholders of a corporation have limited liability.
12. (T)
13. (T)
14. (T)
15. (F) If a liability increases, there would have to be an equal decrease in another liability, an increase in an asset, or a decrease in owner's equity for the basic accounting equation to remain equal.
16. (T)
17. (T)
18. (F) It is the income statement which has revenues listed first, followed by expenses, and then net income (or net loss).
19. (F) The income statement is often referred to as the operating statement.
20. (F) **Management consulting** provides advice to managers of companies concerning various aspects of a company's operations. Examining the financial statements of companies and expressing an opinion as to the fairness of their presentation is the field of auditing.

## MULTIPLE CHOICE

1. (c) **Accounting** is defined as an information system that identifies, records, and communicates economic events of an organization to interested users. The interested users then make the financial decisions based on the information provided.
2. (d) Economic planners, customers, and investors are **external** users of accounting data. Company officers, managers, and employees are **internal** users of accounting data.
3. (b) The FASB has primary responsibility for establishing generally accepted accounting principles. The SEC grants this power to the FASB.
4. (d) The **monetary unit assumption** requires that only transaction data capable of being expressed in terms of money be included in the accounting records. Choice (a) is false because this assumption assumes that the unit of measure remains sufficiently constant over time. Choice (b) is incorrect because the monetary unit assumption is vital in applying the cost principle. Choice (c) is incorrect because this assumption is used for all types of entities.
5. (a) A proprietorship is a business owned by only one person.
6. (c) A net loss will result when expenses exceed revenues. Net income results when revenues exceed expenses.
7. (b) Borrowing from the bank, using office supplies, and paying wages are all recognized as business transactions, thus causing (a), (c), and (d) to be incorrect. Placing an order for merchandise with a supplier is not recognized as a business transaction even though it may lead to a business transaction when the merchandise is delivered by the supplier.
8. (d) The use of office supplies is an internal transaction because an outside party is not involved when the office supplies are used. Answers (a) and (c) involve outside parties and are, therefore, external transactions. Choice (b) is not a transaction.
9. (c) The transaction is an advertising expense that has been incurred on account. Thus, the transaction decreases owner's equity J. Relias, Capital and increases the liability Accounts Payable.
10. (a) The using up of supplies is an expense. Thus, the transaction decreases the asset Supplies and decreases owner's equity L. Nagy, Capital.
11. (d) The withdrawal of cash by an owner for personal use reduces owner's capital. Drawings do not result in either an expense or a receivable.
12. (c) The transaction results in an increase in the asset Equipment and an equal decrease in the asset Cash. Therefore, there is no change in total assets.



13. (d) The effects of the transactions are summarized below.

	<b>Assets</b>	=	<b>Liabilities</b>	+	<b>Owner's Equity</b>
September 17	\$13,000		\$8,000		\$5,000
Cash revenue	+ 500				+ 500
Credit revenue	+ 200				+ 200
Wage expense			+ 80		- 80
September 18	<u>\$13,700</u>	=	<u>\$8,080</u>	+	<u>\$5,620</u>

14. (b) The balance sheet equation states: Assets = Liabilities + Owner's Equity. Thus, if liabilities are \$5,000 and owner's equity is \$7,000, assets must equal \$12,000. The revenue is already in the December 31, 2014 totals and therefore is not relevant to the answer.
15. (a) The income statement reports revenues and expenses as well as net income. The balance sheet reports assets, liabilities, and owner's equity. The owner's equity statement explains the changes in owner's equity. The statement of cash flows shows cash flows.
16. (b) The transaction represents an increase in assets of \$12,000 and an increase in liabilities of an equal amount. The transaction causes a change in balance sheet items only.
17. (b) The balance sheet reports the financial position of a company. The income statement (or operating statement) presents revenues and expenses. The owner's equity statement explains the changes in owner's equity that have occurred during a given period of time.
18. (c) Accounts receivable, M. DeFlippo, Capital, and Wages payable are all balance sheet items causing (a), (b), and (d) to be incorrect. Utilities expense is an item that is reported on the income statement.
- \*19. (a) Auditing is the examination of financial statements by a CPA in order to express an opinion on their fairness. Choice (b) is incorrect because a part of accounting that involves only recording of economic events is bookkeeping. Choice (c) is incorrect because an area of accounting that involves such activities as cost accounting, budgeting, and accounting information systems is private (or managerial) accounting. Choice (d) is incorrect because CPAs perform the actual auditing function, not the SEC.
- \*20. (d) The private accountant might be involved in internal auditing, tax accounting, and designing accounting and information systems, as well as cost accounting, budgeting, and general accounting.

**MATCHING**

- |       |        |        |
|-------|--------|--------|
| 1. c. | 6. f.  | 11. g. |
| 2. j. | 7. o.  | 12. h. |
| 3. i. | 8. d.  | 13. n. |
| 4. e. | 9. b.  | 14. m. |
| 5. k. | 10. a. | 15. l. |

**EXERCISES**

- EX. 1-1** (A) \$33,000 (Revenues \$48,000 - net income \$15,000).  
 (B) \$30,000 (Capital, 12/31 \$33,000 + drawings \$12,000 - net income \$15,000).  
 (C) \$42,000 (Assets \$75,000 - owner's equity \$33,000)  
 (D) \$76,000 (Expenses \$52,000 + net income \$24,000)  
 (E) \$15,000 (Capital, 1/1/ \$45,000 + net income \$24,000 - capital, 12/31 \$54,000)  
 (F) \$110,000 (Liabilities \$56,000 + owner's equity \$54,000)  
 (G) \$18,000 (Revenues \$82,000 - expenses \$64,000)  
 (H) \$51,000 (Capital, 1/1/ \$50,000 + net income \$18,000 - drawings \$17,000)  
 (I) \$51,000 (Assets \$91,000 - liabilities \$40,000).

**EX. 1-2**

Trans- action	Cash	+	Supplies	+	Equipment	=	Accounts Payable	+	L. Fiala Capital	
1.	+\$5,000								+\$5,000	Investment
2.	- 800		+\$800							
	4,200	+	800			=			5,000	
3.	- 2,000				+\$12,000		+\$10,000			
	2,200	+	800	+	12,000	=	10,000	+	5,000	
4.	+ 1,200								+ 1,200	Service Revenue
	3,400	+	800	+	12,000	=	10,000	+	6,200	
5.	- 500								- 500	Salary Expense
	2,900	+	800	+	12,000	=	10,000	+	5,700	
6.	- 400								- 400	Drawings
	<u>\$2,500</u>	+	<u>\$800</u>	+	<u>\$12,000</u>	=	<u>\$10,000</u>	+	<u>\$ 5,300</u>	

**EX. 1-3**

Item	Financial Statement	Item	Financial Statement	Item	Financial Statement
a.	3	e.	3	i.	1
b.	1	f.	1	j.	2
c.	2	g.	2, 3	k.	1, 2
d.	1	h.	3	l.	3