Chapter 1

Introduction to Accounting and Business

Study Guide Solutions

Fill-in-the-Blank Equations

1. Owner's equity
2. Net income or net loss
3. Net income (or subtract if a net loss)
4. Cash flows from investing activities
5. Ratio of liabilities to owner's equity

Exercises

1. Determine if each of the following businesses is an example of a manufacturing, service, or merchandising business.
    - **a.** Service
    - **b.** Merchandising
    - **c.** Manufacturing
2. Are the following examples of a service, manufacturing, or merchandising business?
    - **a.** Merchandising
    - **b.** Service
    - **c.** Manufacturing
3. Determine if each of the following is an example of a manufacturing, service, or merchandising business.
    - **a.** Merchandising
    - **b.** Manufacturing
    - **c.** Service

    Strategy: *Merchandising businesses typically sell products produced by others for profit. Manufacturing businesses earn profit by selling products to others. Service businesses complete a task through a process for clients.*

4. Are the following examples of managerial or financial accounting?

- **a.** Financial accounting
- **b.** Managerial accounting
- **c.** Financial accounting

5. Are the following stakeholders internal or external users in a company? Would each use managerial or financial accounting?

- **a.** External; financial accounting
- **b.** Internal; managerial accounting
- **c.** External; financial accounting

6. Would each of the following be an example of managerial or financial accounting?

- **a.** Financial
- **b.** Managerial
- **c.** Managerial

Strategy: *Managerial accounting is used by internal users of the company, such as managers. External users utilize financial accounting to base decisions on the financial information given.*

7. Determine if each of the following is a characteristic of a proprietorship, partnership, corporation, or limited liability company.

- **a.** Corporation
- **b.** Proprietorship
- **c.** Limited liability company
- **d.** Partnership

8. Determine the type of business entity from the following independent characteristics.

- **a.** Proprietorship
- **b.** Corporation
- **c.** Partnership
- **d.** Limited liability company

9. Do the following separate qualities describe a proprietorship, partnership, corporation, or limited liability company?

- **a.** Limited liability company
- **b.** Corporation
- **c.** Proprietorship
- **d.** Partnership

Strategy: *A sole proprietorship has only one owner, who has full liability for the company. A partnership has two or more partners, who combine resources for profit and usually have liability. A corporation acts as a separate entity, meaning it pays its own taxes and is liable for itself. A limited liability company gives owners limited liability but still has partnership taxation.*

10. Determine the accounting concept that relates to each of the following descriptions.

- **a.** Business entity concept
- **b.** Cost concept
- **c.** Objectivity concept

11. Which accounting concept do the following characteristics define?

- **a.** Unit of measure concept
- **b.** Matching concept
- **c.** Business entity concept

12. Which accounting concept relates to the following examples?

- **a.** Cost concept
- **b.** Objectivity concept
- **c.** Matching concept

Strategy: *Using the basic accounting concepts ensures that the financial statements are fair and accurate.*

13. If a business has the following balances, how much is total liabilities?

$18,975; $21,575 = $18,975 + $2,600

14. During the first year, Fox Supply has total assets of $15,000 and liabilities of $10,875. During the second year, assets increase by $1,375, and owner's equity increases by $950. How much is total liabilities at year-end?

Liabilities for the second year equaled $11,300 ($16,375 – $5,075).

During the first year, the account balances show:

Assets	$15,000	**Liabilities**	$10,875
		Owner's Equity	$4,125

After the second year of operations, the account balances show:

Assets	$16,375	**Liabilities**	$11,300
		Owner's Equity	$5,075

15. Shell Company's Year 5 balance sheet had the following balances: owner's equity of $4,600 and liabilities of $3,800. During the next year, assets increased by $300, and liabilities decreased by $150. What was the change in owner's equity?

The change in owner's equity is $450 ($5,050 – $4,600).

After Year 5, the balances show:

Assets	$8,400	**Liabilities**	$3,800
		Owner's Equity	$4,600

At Year 6 year-end, the balances show:

Assets	$8,700	**Liabilities**	$3,650
		Owner's Equity	$5,050

Strategy: *Liabilities and owner's equity combine to equal assets, so begin by solving the unknown amount at the beginning of the period. Next, find the ending amounts by adding or subtracting the changes given. The amounts should still show that assets equal the sum of liabilities and owner's equity.*

16. Determine the dollar effect on the accounting equation (increase or decrease assets, liabilities, or owner's equity) from the following separate transactions:

a. Increase assets and owner's equity by $4,000

b. Increase assets and liabilities by $1,600

c. Decrease assets and liabilities by $1,300

17. What is the dollar effect on the accounting equation (increase or decrease assets, liabilities, or owner's equity) from the following independent transactions?

- **a.** Decrease assets and owner's equity by $800
- **b.** Increase assets and owner's equity by $290
- **c.** Decrease assets and owner's equity by $1,400

18. Apple Tree had the following balances when formed:

Assets		**Liabilities**	
Cash	$2,400	Notes payable	$1,500
Equipment	1,300	**Owner's Equity**	
		Johnny, capital	2,200
Total assets	$3,700	Total liabilities and owner's equity	$3,700

During the first year of operations, the following transactions occurred:

- Collected $12,000 cash in rental revenue.
- Made a $2,000 investment in equity securities using $1,000 cash and a $1,000 note payable.
- Incurred and paid $2,000 in cash for utilities expense, $3,500 in rent expense, and $2,200 in wages expense.
- Johnny, Apple Tree's owner, withdrew $200 in cash from the business and contributed $1,500 in equipment.

Show the cumulative effect on the accounting equation from the transactions for the year.

	Assets	=	**Liabilities**	+		**Owner's Equity**		
Cash	Equipment	Investments	Notes Payable	Johnny, Capital	Rental Revenue	Utilities Exp.	Rent Exp.	Wages Exp.
2,400	1,300		1,500	2,200				
12,000					12,000			
(1,000)		2,000	1,000					
(7,700)						(2,000)	(3,500)	(2,200)
(200)				(200)				
	1,500			1,500				
5,500	2,800	2,000	2,500	3,500	12,000	(2,000)	(3,500)	(2,200)

Strategy: *First, determine which accounts the transaction affects and if the account is an asset, liability, or owner's equity account. Owner's equity contains net income, which means revenues and expenses transactions will be included. Next, determine if the amount will increase or decrease the account. The accounting equation should still balance after showing the increases and/or decreases.*

19. Determine to which financial statement the following descriptions relate.

- **a.** Balance sheet
- **b.** Statement of cash flows
- **c.** Income statement
- **d.** Statement of owner's equity

20. Which financial statement is associated with each of the descriptions below?

- **a.** Statement of cash flows
- **b.** Balance sheet
- **c.** Income statement
- **d.** Statement of owner's equity

21. Which financial statement is associated with each of the descriptions below? Also, put the financial statements in order as they should be prepared.

- **a.** Statement of cash flows (4th)
- **b.** Balance sheet (3rd)
- **c.** Statement of owner's equity (2nd)
- **d.** Income statement (1st)

Strategy: *To prepare financial statements in the correct order, it is important to know which amounts flow to the next financial statement to be prepared. The income statement will show net income or loss from the revenues and expenses. The statement of owner's equity details the changes in an owner's investment in the company. Because the owner's investment produces the income, net income should be included. The year-end owner's equity flows to the balance sheet. The statement of cash flows includes cash and all other activities to arrive at the year-end cash balance and to match the balance sheet.*

22. Given the following transactions for the year, prepare the income statement for World Co. for the year ended December 31, 20Y5.

- Rental revenue of $15,000
- Wages expense of $3,500
- Rental expense of $5,300
- Miscellaneous expense of $1,200

World Co.
Income Statement
For the Year Ended December 31, 20Y5

Rental revenue		$15,000
Expenses:		
Rental expense	$5,300	
Wages expense	3,500	
Miscellaneous expense	1,200	
Total expenses		10,000
Net income		$ 5,000

23. Create World Co.'s statement of owner's equity using net income from Exercise 22. At the beginning of the year, John Green's owner capital account had a balance of $12,000, with the following changes during the year:

- Additional cash contributions of $1,500
- Cash withdrawals of $2,100

World Co.
Statement of Owner's Equity
For the Year Ended December 31, 20Y5

John Green, capital, January 1, 20Y5		$12,000
Contributions	$ 1,500	
Net income for the year	5,000	
Withdrawals	(2,100)	
Increase in owner's equity		4,400
John Green, capital, December 31, 20Y5		$16,400

24. Using the information from Exercise 23, prepare World Co.'s balance sheet if the company had the following balances:

- Accounts payable: $2,300
- Inventory: $5,000
- Accounts receivable: $1,400
- Cash: $1,500
- Property, plant, and equipment: $12,000
- Notes payable: $1,200

World Co.
Balance Sheet
December 31, 20Y5

Assets		**Liabilities**	
Cash	$ 1,500	Accounts payable	$ 2,300
Accounts receivable	1,400	Notes payable	1,200
Inventory	5,000	**Owner's Equity**	
PP&E	12,000	John Green, capital	16,400
Total assets	$19,900	Total liabilities and owner's equity	$19,900

25. Prepare World Co.'s statement of cash flows using the year-end amount from Exercise 24. During the first year of operations, the following activities occurred:

- Cash revenue of $13,600
- Cash contribution from owner of $1,500
- Cash payments for expenses of $10,000
- Cash received from notes payable of $1,800
- Purchase of new equipment for $3,300
- Cash withdrawals by owner of $2,100

World Co.
Statement of Cash Flows
For the Year Ended December 31, 20Y5

Cash flows from operating activities:		
Cash received from customers	$ 13,600	
Cash payments for expenses	(10,000)	
Net cash flow from operating activities		$ 3,600
Cash flows from investing activities:		
Cash payments for equipment		(3,300)
Cash flows from financing activities:		
Cash received from owner as investment	$ 1,500	
Cash received from notes payable	1,800	
Cash withdrawals by owner	(2,100)	
Net cash flow from financing activities		1,200
Net increase in cash during year		$ 1,500
Cash as of January 1, 20Y5		0
Cash as of December 31, 20Y5		$ 1,500

26. If the following transactions occurred for the year June 30, 20Y5, what is Purple Sun's net income or net loss? Find the amount using an income statement.

- Earned fees of $21,700
- Utilities expense of $2,300
- Miscellaneous expense of $4,300
- Interest expense of $1,200
- Wages expense of $4,200

Purple Sun
Income Statement
For the Year Ended June 30, 20Y5

Fees earned		$21,700
Expenses:		
Wages expense	$4,200	
Utilities expense	2,300	
Interest expense	1,200	
Miscellaneous expense	4,300	
Total expenses		12,000
Net income		$ 9,700

27. Using the net income found in Exercise 26 and the information below, create Purple Sun's statement of owner's equity. The total owner's equity at the beginning of the year equaled $16,700.

- Fred D. (owner) contributed cash of $2,300.
- Fred D. made a $6,200 withdrawal.

Purple Sun
Statement of Owner's Equity
For the Year Ended June 30, 20Y5

Fred D., capital, July 1, 20Y4		$16,700
Contributions	$ 2,300	
Net income for the year	9,700	
Withdrawals	(6,200)	
Increase in owner's equity		5,800
Fred D., capital, June 30, 20Y5		$22,500

28. Create Purple Sun's balance sheet using the amounts found in Exercise 27 and the following account balances:

- Property, plant, and equipment: $18,800
- Cash: $6,200
- Accounts payable: $4,000
- Investments in securities: $1,500

Purple Sun
Balance Sheet
June 30, 20Y5

Assets		**Liabilities**	
Cash	$ 6,200	Accounts payable	$ 4,000
Investments in securities	1,500	**Owner's Equity**	
PP&E	18,800	Fred D., capital	22,500
Total assets	$26,500	Total liabilities and owner's equity	$26,500

29. At the beginning of the year, Purple Sun had a cash balance of $3,100. Prepare the statement of cash flows given the following information and the ending cash balance from Exercise 28.

- Purchased land for $12,000; $6,000 cash and issued $6,000 long-term note payable to the seller
- Cash received from customers, $20,000
- Cash received from owner, $2,300
- Cash withdrawal made by owner, $6,200
- Cash payments for expenses, $7,000

Purple Sun
Statement of Cash Flows
For the Year Ended June 30, 20Y5

Cash flows from operating activities:		
Cash received from customers	$20,000	
Cash payments for expenses	(7,000)	
Net cash flow from operating activities		$13,000
Cash flows from investing activities:		
Cash payments for land		(6,000)
Cash flows from financing activities:		
Cash received from owner as investment	$ 2,300	
Cash withdrawal by owner	(6,200)	
Net cash flow from financing activities		(3,900)
Net increase in cash during year		$ 3,100
Cash as of July 1, 20Y4		3,100
Cash as of June 30, 20Y5		$ 6,200

30. With the following transactions, create Polka Dot's income statement for the year ended September 30, 20Y5.

- Interest revenue of $23,000
- Interest expense of $14,000
- Rent expense of $4,000
- Legal expense of $1,400
- Wages expense of $3,200
- Miscellaneous expense of $2,200

Polka Dot
Income Statement
For the Year Ended September 30, 20Y5

Interest revenue		$23,000
Expenses:		
Interest expense	$14,000	
Rent expense	4,000	
Wages expense	3,200	
Legal expense	1,400	
Miscellaneous expense	2,200	
Total expenses		24,800
Net loss		$(1,800)

Strategy: *The title should include the name of the company, the title of the financial statement (Income Statement), and the period of time that the financial statement covers (for the year ended, for the period ended). First, begin with revenue. Expenses come after the revenue to show that the expenses were incurred during the same time to produce the revenue. Subtract the total expenses from total revenue to find the net profit (positive amount) or net loss (negative amount).*

31. Polka Dot's owner, Ellen Pink, had beginning capital in the company of $3,000 for the year. During the year, she made a withdrawal of $1,000. Prepare the statement of owner's equity for the year using the net income and information from Exercise 30.

Polka Dot
Statement of Owner's Equity
For the Year Ended September 30, 20Y5

Ellen Pink, capital, October 1, 20Y4		$ 3,000
Net loss	$(1,800)	
Withdrawal	(1,000)	
Decrease in owner's equity		(2,800)
Ellen Pink, capital, September 30, 20Y5		$ 200

Strategy: *The title should include the name of the company, the title of the financial statement (Statement of Owner's Equity), and the period of time that the financial statement covers (for the year ended, for the period ended). First, begin with the capital investment at the beginning of the year. Next, find the net increase or decrease for the year from the activity for the year. The net increase or decrease is added to the beginning capital amount to calculate the ending balance.*

32. Using the ending capital balance from Exercise 31, create Polka Dot's balance sheet. The company had the following ending account balances:

- Cash: $1,900
- Investment in securities: $22,000
- Notes payable: $20,000
- Property, plant, and equipment: $5,000
- Interest payable: $4,200
- Accounts payable: $4,500

Polka Dot
Balance Sheet
September 30, 20Y5

Assets		**Liabilities**	
Cash	$ 1,900	Accounts payable	$ 4,500
Investments in securities	22,000	Interest payable	4,200
PP&E	5,000	Notes payable	20,000
		Owner's Equity	
		Ellen Pink, capital	200
Total assets	$28,900	Total liabilities and owner's equity	$28,900

Strategy: *The title should include the name of the company, the title of the financial statement (Balance Sheet), and the date that the account balances are measured. The balance sheet shows amounts as of a certain date. First, find the sum of the total assets. Next, calculate total liabilities. Last, add the total owner's equity, carrying over the capital measured for the year-end from the statement of owner's equity.*

33. At the beginning of the year, Polka Dot's bank statement showed a balance of $5,200 for cash. With the transactions below, reconcile the beginning to ending amount from Exercise 32 using a statement of cash flows.

- Cash received from interest, $20,000
- Cash paid for interest, $12,000
- Cash paid for expenses, $17,300
- Withdrawal by owner, $1,000
- Cash paid for new building, $5,000
- Cash received from customers, $12,000

Polka Dot
Statement of Cash Flows
For the Year Ended September 30, 20Y5

Cash flows from operating activities:		
Cash received from customers	$ 12,000	
Cash payments for expenses	(17,300)	
Net cash flow from operating activities		$(5,300)
Cash flows from investing activities:		
Purchase of building		(5,000)
Cash flows from financing activities:		
Interest received	$ 20,000	
Interest paid	(12,000)	
Withdrawal by owner	(1,000)	
Net cash flow from financing activities		7,000
Net decrease in cash during year		$(3,300)
Cash as of October 1, 20Y4		5,200
Cash as of September 30, 20Y5		$ 1,900

Strategy: *The title should include the name of the company, the title of the financial statement (Statement of Cash Flows), and the period of time that the financial statement covers (for the year ended, for the period ended). The first section should be Cash flows from operating activities, which are the main operations of the business. The second section is Cash flows from investing activities, which includes activities for long-term investments. The last section is Cash flows from financing activities, which includes activities used to finance the operations of the company.*

34. Given the following company's balances for liabilities and owner's equity, calculate the ratio of liabilities to owner's equity. Round answers to two decimal places. Indicate the company with the lowest credit risk for creditors and the company with the highest risk.

Company	Liabilities	Owner's Equity	Ratio
World Co.	$ 3,500	$16,400	0.21
Purple Sun	4,000	22,500	0.18
Polka Dot	28,700	200	143.50

Purple Sun's creditors have the lowest risk, while Polka Dot's creditors have the highest risk.

35. Blue Company's account balances for liabilities and owner's equity for the past two years are shown below. Calculate the ratio of liabilities to owner's equity, rounding to two decimal places. Then, indicate if the company's creditors are more or less at risk.

	12/31/20Y6	12/31/20Y5
Liabilities	$15,000	$14,750
Owner's equity	$14,800	$14,000
Ratio	1.01	1.05

Because the ratio decreased from 20Y5 to 20Y6, the company's creditors are less at risk. The company's creditors are more likely to receive their investment after paying the liabilities.

36. Calculate the ratio of liabilities to owner's equity with the information given for Broom Co., rounding to two decimal places. Then, indicate if the company's creditors are more or less at risk than the previous year.

	12/31/20Y6	12/31/20Y5
Liabilities	$90,250	$87,000
Owner's equity	$60,000	$67,000
Ratio	1.50	1.30

Because the company's ratio of liabilities to owner's equity increased, the company's creditors are more at risk. The creditors are less likely to receive the amount they invested after repayment of the company's liabilities.

Strategy: *The ratio of liabilities to owner's equity indicates the amount of risk creditors may have to receive the amount of their investment. The higher the ratio, the less likely the owners will receive their repayment. The company will have more liabilities to repay before paying the owner investments because the owners are paid last.*