Part 1

Basic Concepts

Learning Objectives

In this part you will learn:

- The nature of the balance sheet.
- The accounting meaning of assets, liabilities, and equity.
- The first five of the nine concepts that govern all accounting:
    - The dual-aspect concept.
    - The money-measurement concept.
    - The entity concept.
    - The going-concern concept.
    - The asset-measurement concept.
- The meaning of the principal items reported on a balance sheet.

1-1. Accounting is a language. The purpose of any language is to convey information. Accounting information is provided by reports called **financial statements.** This program helps you understand what the numbers in the financial statements mean and how they can be used. Please tear out Exhibit 1 (in the separate booklet) to see one of these financial statements. As indicated by the title at the top of the page, this report is called a _ _ _ _ _ _ _ sheet.

Balance

On an item like this, fill in one letter for each underline and then compare it with the correct answer, found here.

NOTE: Be sure to cover up the answers with the mask provided.

ELEMENTS OF THE BALANCE SHEET

1-2. A balance sheet gives financial information about an **entity.** The name of the entity that this balance sheet refers to is ___________________.

Garsden Company

1-3. An entity is any organization for which financial statements are prepared. A business is an __________; a college, a government, a church, and a synagogue are also ______________.

entity
entities

1-4. The balance sheet is a snapshot of the financial position of the entity as of one moment in time. As indicated by the heading in Exhibit 1, the balance sheet for Garsden Company reports its financial position as of December 31, ________.

2006

1-5. The date December 31, 2006, means [circle A or B]:

A. it was prepared on December 31, 2006.

B. it reports the entity's financial position as of December 31, 2006.

B
(Probably, it was prepared early in 2007.)

1-6. The Garsden Company balance sheet has two sides. The heading of the left side is A ________, and the heading of the right side is L ______________ and E ________. We shall describe the meaning of each side.

Assets
Liabilities Equity

ASSETS

1-7. Assets are valuable resources owned by the entity. An entity needs cash, equipment, and other resources in order to operate. These resources are its a ______. The balance sheet shows the amounts of each of these assets as of a certain date.

assets

1-8. Assets are resources **owned** by Garsden Company. Its employees, although usually its most valuable resource, . . . [are / are not] accounting assets.

are not
(No one owns humans since the abolition of slavery.)

NOTE: On an item like this, circle the answer of your choice.

LIABILITIES AND EQUITY

1-9. The right side of the balance sheet shows the sources of funds that provided the entity's assets. As the heading indicates, there are two general types of sources, L _ _ _ _ _ _ _ _ _ _ and E _ _ _ _ _.

Liabilities
Equity

1-10. Liabilities are the entity's obligations to outside parties who have furnished resources. These parties are generally called **creditors** because they have extended credit to the entity. As Exhibit 1 indicates, suppliers have extended credit in the amount of $5,602,000 as indicated by the item A _ _ _ _ _ _ _ _ P _ _ _ _ _ _ _.

Accounts Payable

1-11. Creditors have a **claim** against the assets in the amount shown as the liability. For example, a bank has loaned funds to Garsden Company, and therefore has a current claim of $1,000,000 of this amount, as indicated by the item, _ _ _ _   _ _ _ _   _ _ _ _ _ _ _.

Bank Loan Payable

1-12. Because an entity will use its assets to pay its claims, the claims are claims against _ _ _ _ _ _. They are claims against all the assets, not any particular asset.

assets

1-13. The other source of the funds that an entity uses to acquire its assets is called **Equity.** In Garsden Company, equity investors provided funds for which they received common stock. The total amount supplied by equity investors is called **Total Paid-in Capital.** In Garsden Company, it was $__ __ , __ __ __ ,000. (We shall describe the details in a later part.)

$12,256,000

> **NOTE:** The term is "Equity" (singular) not "Equities" (plural) even though there are several sources of equity.

1-14. Equity funds also come from a second source, the profits or **earnings** generated by the entity. The amount of these earnings that has not been paid to equity investors in the form of dividends is retained in the entity, and therefore is called __ __ __ __ __ __ __ __ Earnings. In Garsden Company, the amount was $__ __ , __ __ __ ,000.

Retained
$13,640,000

1-15. Creditors can sue the entity if the amounts due them are not paid. Equity investors have only a *residual claim;* if the entity is dissolved, they get whatever is left after the liabilities have been paid, which may be nothing. Liabilities therefore are a . . . [stronger / weaker] claim against the assets, and equity is a . . . [stronger / weaker] claim.

stronger
weaker

DUAL-ASPECT CONCEPT

1-16. Whatever assets remain after the liabilities are taken into account will be claimed by the equity investors. Consider the case of an entity whose assets total $10,000, and whose liabilities total $4,000. Its equity must be $______________.

> ***A single blank indicates that the answer is one word or, when preceded by the dollar sign as it is here, one amount.***

$6,000 = ($10,000 – $4,000)

1-17. (1) Any assets not claimed by creditors will be claimed by equity investors, and (2) the total amount of claims (liabilities + equity) cannot exceed what there is to be claimed. Therefore, the total amount of assets will always be . . . [greater than / equal to / less than] the total amount of liabilities plus equity.

equal to

1-18. Here is the balance sheet of Garsden Company, greatly condensed so as to focus on the main elements, and disregarding the thousands:

GARSDEN COMPANY
Balance Sheet as of December 31, 2006
(000 omitted)

Assets		Liabilities & Equity	
Cash	$ 1,449	Liabilities	$12,343
Other Assets	36,790	Equity	25,896
Total	$38,239	Total	$38,239

The total of the left side is $__ __, __ __ __,000, and the total of the right side is $__ __, __ __ __,000.

$38,239,000
$38,239,000

1-19. This is another way of saying that total assets must always equal total __ __ __ __ __ __ __ __ __ __ __ plus __ __ __ __ __ __.

liabilities equity

1-20. The fact that total assets must equal, or **balance,** total liabilities plus equity is why the statement is called a __ __ __ __ __ __ __ __ __ __ __ __ __. This equality tells nothing about the entity's financial condition; it always exists unless the accountant has made a mistake.

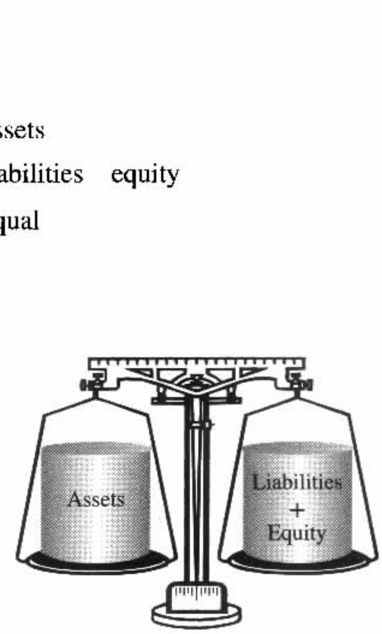
balance
sheet

1-21. This equality leads to what is called the **dual-aspect concept.** The two aspects to which this concept refers are (1) ____________ and (2) ____________ plus ____________, and the concept states that these two aspects are always ____________. (In what relation to each other?)

assets
liabilities equity
equal

1-22. The dual-aspect concept is the first of nine fundamental accounting concepts we shall describe in this program. The concept can be written as an equation, that is, a statement that something is equal to something else. Write this equation, using the words Assets, Liabilities, and Equity:

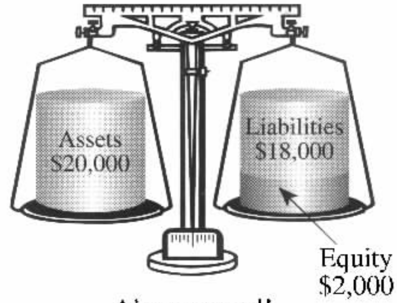
____________ = ____________ + ____________



Assets = Liabilities + Equity

1-23. Suppose a business had assets totaling \$20,000 and liabilities totaling \$18,000. Evidently, its equity was \$______________.

\$2,000 = (\$20,000 – \$18,000)



Always equal!

The two sides **balance.**

1-24. At the close of business on December 31, 2005, Dowling Company had \$2,000 in its bank account. It owned other assets totaling \$24,000. The company owed \$10,000 to creditors. Its equity was \$16,000. Complete the balance sheet for Dowling Company:

DOWLING COMPANY

Balance Sheet as of ________________

Assets		Liabilities and Equity	
Cash	\$	Liabilities	\$
Other Assets		Equity	
Total	\$	Total	\$

December 31, 2005

\$ 2,000	\$10,000
24,000	16,000
\$26,000	\$26,000

1-25. If Dowling Company prepared a balance sheet as of the beginning of business the next day, January 1, 2006, would it be different from the one you prepared above? . . . [Yes / No]

No (*because nothing changes between the close of business on one day and the beginning of business on the next day*)

1-26. The term "Net Assets" is sometimes used instead of "Equity." It refers to the fact that equity is always the difference between A ______________ and L ______________. (We shall describe the details in a later part.)

Assets

Liabilities

> **NOTE:** You will see the term "Net Assets" instead of "Equity" on some balance sheets. We will describe accounting for nonprofit entities later.

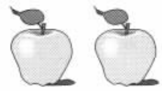
MONEY-MEASUREMENT CONCEPT

1-27. If a fruit store owned $200 in cash, 100 dozen oranges, and 200 apples, could you add up its total assets from this information? . . . [Yes / No]

No (*because you can't add apples and oranges*)

Cash $200

100 dozen



200

Can't add

1-28. To add together objects as different as apples, oranges, automobiles, shoes, cash, supplies, and so on, they must be stated in . . . [different / similar] units.

similar

1-29. Can you add the amounts of apples and oranges if they are stated in terms of money? . . . [Yes / No]

Yes (*You could also add them to get "pieces of fruit," but this is not a useful number for accounting purposes.*)

1-30. The facts that appear in an accounting report are stated in units of money; that is, dollars and cents. This is the **money-measurement concept.** By converting different facts to monetary amounts, we can deal with them . . . [verbally / arithmetically]; that is, we can add one item to another, or we can ______________ one item from another.

arithmetically

subtract

1-31. The money-measurement concept states that accounting reports only those facts that can be stated as m _ _ _ _ _ _ _ a _ _ _ _ _ _ .

monetary

amounts

1-32. If facts cannot be expressed in monetary terms, they cannot be reported on a balance sheet. Which of the following facts could be learned by reading a balance sheet of Able Company?

A. How much cash Able Company has.

B. The health of the president of Able Company.

C. How much money Able Company owes.

D. A strike is beginning at Able Company.

E. How many automobiles Able Company owns.

A and C
(*Not E because the number of automobiles is not a monetary amount.*)

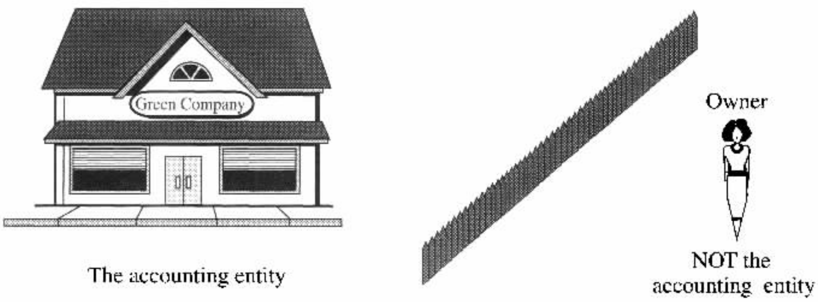
1-33. Because accounting reports include only facts that can be stated in monetary amounts, accounting is necessarily a(n) . . . [complete / incomplete] record of the status of a business and . . . [does / does not] always give the most important facts about a business.

incomplete
does not

ENTITY CONCEPT

1-34. Accounts are kept for **entities,** rather than for the persons who own, operate, or otherwise are associated with those entities. For example, suppose Green Company is a business entity, and Sue Smith is its owner. Sue Smith withdraws $100 from the business. In preparing financial accounts for Green Company, we should record the effect of this withdrawal on the accounts of . . . [Sue Smith / the entity].

the entity



1-35. Sue Smith withdraws $100 from Green Company, of which she is the sole owner. Smith now has $100 more cash, but she has $100 less equity in Green Company. Smith is . . . [better off / worse off / no better or worse off] than she was before.

no better or worse off

1-36. [If Smith withdraws $100 from Green Company, of which she is the sole owner, she is just as well off after this withdrawal as before.] What about Green Company? It now has . . . [$100 more / the same amount / $100 less] in assets.

$100 less

1-37. The fact that accounts are kept for entities as distinguished from the persons associated with those entities is called the e ________ concept.

entity

1-38. Owners of some small retail stores (called "mom and pop" stores) may not identify the cost of merchandise they withdraw for personal use, personal telephone calls, and the like. If this is so, then they do not apply the __ __ __ __ __ __ concept. Consequently, the financial statements of these stores are inaccurate.

entity

> **NOTE:** A business may be organized under any one of several legal forms: a corporation, a partnership (two or more owners), or a proprietorship (a single owner). The entity concept applies regardless of the legal status.

1-39. John and Ellen own the John and Ellen Laundry, a partnership. Each takes \$1,000 cash from the partnership entity and deposits it into a personal bank account. An accounting report of the financial position of the John and Ellen Laundry would show that:

A. the change in the entity's equity is zero.
B. the entity has \$2,000 less cash.
C. the entity has \$2,000 less equity.
D. John and Ellen each have \$1,000 more cash.

B and C
(John's and Ellen's personal statements would show that each had \$1,000 more cash.)

> **NOTE:** Municipalities, hospitals, religious organizations, colleges, and other nonprofit or nonbusiness organizations are also accounting entities. Although in this program we focus primarily on businesses, the accounting for nonprofit entities is similar. (We will describe accounting for nonprofit entities later.)

GOING-CONCERN CONCEPT

1-40. Every year some entities go bankrupt or cease to operate. Most entities, however, keep on going from one year to the next. Accounting must assume either that (a) entities are about to cease operations, or (b) they are likely to keep on going. The more realistic assumption for most entities is . . . [(a) / (b)].

(b)

1-41. Accounting assumes that an entity, or **concern,** normally will keep on **going** from one year to the next. This assumption is therefore called the g __ __ __ __ **- concern concept.**

going

1-42. Specifically, the g _ _ _ _ - c _ _ _ _ _ _ concept states that accounting assumes that an entity will continue to operate indefinitely unless there is evidence to the contrary.	going-concern

> **NOTE:** If the entity is not a going concern, special accounting rules apply; they are not discussed in this introductory program.

1-43. Because of the going-concern concept, accounting . . . [does / does not] report what the assets could be sold for if the entity ceases to exist.	does not

> **NOTE:** We next describe the concepts that govern the measurement of asset amounts on the balance sheet. Most monetary assets are reported at their *fair value*, and most nonmonetary assets are reported at an amount that is based on their *cost*. These concepts, and the reasoning behind them, are introduced in this section.

ASSET-MEASUREMENT CONCEPT

1-44. Readers of the balance sheet want to know what the reported assets are worth. In accounting, the name for what an asset is "worth" is its *fair value* (also called *market value*). The Garsden Company balance sheet (Exhibit 1) reported that the company's cash on December 31, 2006, was $1,449,000. This was the f _ _ _ v _ _ _ _ of the asset Cash. We can be reasonably certain that the amount was actually $1,449,000 because the banks in which cash was deposited have reliable records of the amount.	fair value
1-45. Also, we can be reasonably certain that the _ _ _ _ _ _ _ _ _ of marketable securities was $246,000 because a stock exchange publishes a reliable record of the value as of December 31, 2006, for each security that it trades.	fair value
1-46. In general, an asset is reported at its fair value when reliable information as to its market value is available. Usually, this information is obtained from an outside party. Thus, the concept is: **If reliable information is available, an asset is measured as its _ _ _ _ _ _ _ _ _ .**	fair value