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 see Exhibit 1 (at the back of this book) to view a sample financial statement. 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, __ __ __ __ .

2009

1-5. The date December 31, 2009, means [circle A or B]:

A. it was prepared on December 31, 2009.

B. it reports the entity's financial position as of December 31, 2009.

B (*Probably, it was prepared early in 2010.*)

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

NOTE: Note that the last three "000" are omitted on the balance sheet.

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 $________.

$6,000 = ($10,000 – $4,000)

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

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, 2009
(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.

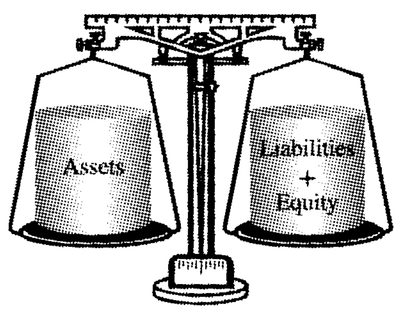
balance
sheet

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:*

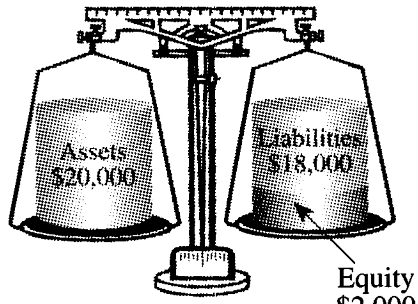
____________ = ____________ + ____________



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, 2008, 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, 2008

$ 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, 2009, 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

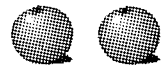
NOTE: You will see the term "net assets" instead of "equity" on some balance sheets. We will describe accounting for nonprofit entities later.

MONEY-MEASUREMENT CONCEPT

1-27. If a fruit store had $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.

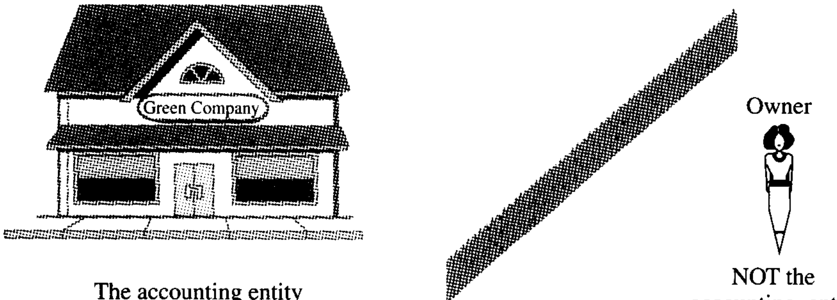
incomplete

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



The accounting entity

NOT the accounting 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 *(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.)*

1-36. 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, 2009, 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, 2009, 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

1-47. The fair value of most assets is known on the date the asset was acquired because the buyer and the seller agreed on the amount. If Garsden Company purchased a plot of land in 1999 for $100,000, this land would have been reported on its December 31, 1999, balance sheet as $100,000. What was its fair value on December 31, 2009?

A. $100,000
B. More than $100,000
C. Garsden doesn't know.

C *(The fair value may have changed for any number of good reasons.)*

1-48. Because it doesn't know the fair value of the land on December 31, 2009, Garsden would report the amount at $100,000, which was its _ _ _ _.

cost

1-49. If on December 31, 2009, Garsden owned machinery that it had purchased five years earlier for $50,000 with an estimated life of 10 years, it would probably report the asset amount as [$50,000 / less than $50,000] representing the amount of cost that has not yet been used up. (Calculating this amount involves depreciation, described in Part 7.)

less than $50,000

1-50. In general, land, buildings, equipment, and inventories have this characteristic; their f _ _ _ v _ _ _ _ cannot be reliably measured except at the time they were acquired. They are reported at _ _ _ _ or a number based on cost.

fair value

cost

1-51. The asset-measurement concept combines both types of assets illustrated above. It is: **If reliable information is available, the amount of an asset is measured at its _ _ _ _ _ _ _ _ _. Otherwise the measurement is based on its _ _ _ _.**

fair value

cost

1-52. There are two reasons for measuring some assets at cost. First, estimating fair value of each asset may be expensive and unreliable. If you bought a pair of shoes for $100 in 2008 and asked two friends in 2009 for the shoes' value, they probably would disagree. Even if the estimates were made by professionals, the appraised value of each asset in a company would be [subjective / objective] and [expensive / inexpensive].

subjective *(that is, influenced by personal feelings rather than facts)*
expensive

1-53. Second, many assets are not going to be sold in the near future; they will be used in ongoing operations. The entity and those who use its balance sheet therefore [do / do not] need to know the fair value of these assets. This reason stems from the previous concept, the g ___ ___ ___ ___ - c ___ ___ ___ ___ ___ ___ concept.

do not

going-concern

1-54. To summarize, the two reasons that accounting focuses on costs, rather than on fair values for some assets, are:

1. fair values are difficult to estimate; that is, they are [objective / subjective], whereas costs are [objective / subjective], and
2. the ___ ___ ___ ___ ___ - ___ ___ ___ ___ ___ ___ ___ concept makes it unnecessary to know the market value of many assets; we assume the assets will be used in future operations rather than being sold immediately.

subjective
objective
going-concern

1-55. The decision of whether an asset is accounted for at fair value or at cost is usually made at the time the asset is acquired. For example, if a shoe retailer purchased an inventory of shoes for $1,000, they would be accounted for at (or recorded at) $1,000, which was their ___ ___ ___ ___. If the retailer expected to sell the shoes for at least $1,500, they would be reported on the balance sheet at [$1,000 / $1,500 / somewhere between $1,000 and $1,500].

cost

$1,000 *(Any higher amount is a subjective opinion.)*

1-56. Monetary assets are those that have a claim on a specified amount of money. Cash, securities, and bonds mentioned earlier are [monetary / nonmonetary] assets. Land, buildings, equipment, and inventory are [monetary / nonmonetary] assets. In general, but with some exceptions described in later parts, **monetary assets are reported at fair value; nonmonetary assets are reported at cost or an amount based on cost.**

monetary

nonmonetary

1-57. Accounting does not report what many of the individual assets are worth, that is, their f ___ ___ ___ v ___ ___ ___ ___ . Accounting therefore [does / does not] report what the whole entity is worth. Those who criticize accounting for its failure to report an entity's "worth" do not appreciate that to do so would be difficult, subjective, and usually unnecessary.

fair value

does not

REVIEW OF ACCOUNTING CONCEPTS

1-58. The asset-measurement concept is the fifth of the nine fundamental accounting concepts. The first five are:

1. dual-aspect concept
2. money-measurement concept
3. entity concept
4. going-concern concept
5. asset-measurement concept

The dual-aspect concept is:

___ ___ ___ ___ ___ ___ =

___ ___ ___ ___ ___ ___ ___ ___ ___ ___ ___ + ___ ___ ___ ___ ___ ___ .

Assets =

Liabilities + Equity

The money-measurement concept is:

Accounting reports only facts that can be expressed in m ___ ___ ___ ___ ___ ___ ___ a ___ ___ ___ ___ ___ ___ .

monetary amounts

The entity concept is:

Accounts are kept for e ___ ___ ___ ___ ___ ___ ___ as distinguished from the p ___ ___ ___ ___ ___ ___ who own those entities.

entities

persons

The going-concern concept is:

Accounting assumes that an e _______ will continue to operate i _______________. | entity indefinitely

The asset-measurement concept is:

Accounting focuses on the _____ _______ of monetary assets and on the ______ of nonmonetary assets. That is, it focuses on how we measure assets on the balance sheet. | fair value cost

BALANCE SHEET ITEMS

1-59. Refer to Exhibit 1. This is the balance sheet we introduced earlier. It reports the amounts of a _______, l _______________, and e _______ of Garsden Company as of ___________. | assets liabilities equity December 31, 2009

1-60. Remember that the note "($000 omitted)" means that the numbers are reported in thousands of dollars. For example, the number reported for Cash, $1,449, means that the amount of cash was $___________. This is common practice. It is done to make the numbers easier to read; users are not interested in the details of the last three digits. | $1,449,000

1-61. Recall also that the total of the assets always equals the total of the liabilities plus equity. Total assets were $___________, and total liabilities plus equity were $___________. | $38,239,000 $38,239,000

1-62. Most items on a balance sheet are summaries of more detailed accounts. For example, the cash is probably located in a number of separate bank accounts, in cash registers, and in petty cash boxes. The total of all the cash is $___________, rounded to the nearest thousand dollars. | $1,449,000 (*NOT $1,449*)

> **NOTE:** Please refer back to Exhibit 1. It is the balance sheet for Garsden Company. In this next part, we explain the meaning of some of the items on this balance sheet. Those not described here will be explained in later parts.

ASSETS

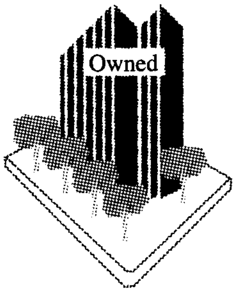
1-63. Assets are valuable resources. Let's make this idea more specific. In order to count as an _ _ _ _ _ in accounting, an item must pass three tests.

asset

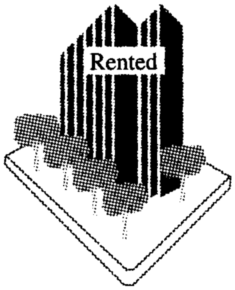
1-64. The first requirement is that the item must be **controlled** by the entity. Usually this means that the entity must **own** the item. If Able Company rents a building owned by Baker Company, this building [is / is not] an asset of Able Company. The building [is / is not] an asset of Baker Company.

is not
is

> **NOTE:** Certain leased items, called capital leases, are assets and are an exception to this rule. They are described in Part 7.



An asset



Not an asset

1-65. In accounting, the employees of an entity are not assets because the entity does not __________ them. However, if a baseball club owns a contract in which a player agrees to provide services, the contract [is / is not] an asset.

own

is (*The asset is the contract, not the player, and it is an asset only if it passes the third test, in Frame 1-67.*)

1-66. The second requirement is that the item must be **valuable** to the entity. Which of these would qualify as assets of a company that sells dresses?

A. The company's right to collect amounts owed by customers.
B. Regular dresses held for sale.
C. Dresses that no one wants because they have gone out of style.
D. A cash register in working condition.
E. A cash register that doesn't work and can't be repaired.

A, B, and D

1-67. The third requirement is that the item must have been acquired at a **measurable cost.** Jones Company bought a trademark from another company for $1 million; this trademark [is / is not] an asset of Jones Company. | is

1-68. By contrast, if Jones Company has built up an excellent reputation because of the consistently high quality of its products, this reputation [is / is not] an asset in accounting, even though it may be worth many millions of dollars. | is not

1-69. To summarize, for an item to be listed as an asset, it must meet three requirements:

1. It must be ___ ed or c _______ ed by the entity; | owned controlled
2. It must be v _______ to the entity; and | valuable
3. It must have been acquired at a m _________ c ___ . | measurable cost

NOTE: Assets are divided into two main categories—current and noncurrent—and liabilities also are divided into these categories. They are introduced in the following section and explained in more detail in Part 2.

1-70. Current assets are cash and other assets that are expected to be converted into cash or used up in the near future, usually within one year. Groceries on the shelves of a grocery store [are / are not] current assets. The store building [is / is not] a c _______ a _____. On the balance sheet, current assets are usually reported separately from noncurrent assets. They are expected to be converted to cash within a year. | are; is not current asset

PLEASE DON'T PEEK: If you look at the answer before writing your response, you will lose much of the educational value.

1-71. Current assets consist of c ____ and of assets that are expected to be converted into c ____ or used up within a short period, usually within ________ ________ (how long?). | cash; cash; one year

1-72. As the name suggests, assets that are expected to be useful for longer than one future year are called [current / noncurrent] assets. | noncurrent

LIABILITIES

1-73. The right-hand side of the Garsden Company balance sheet lists the company's liabilities and equity. These can be regarded either as c _ _ _ _ _ _ against the assets or as the s _ _ _ _ _ _ _ from which the assets were acquired. The claims of creditors and other outside parties are called l _ _ _ _ _ _ _ _ _ _ .

claims sources

liabilities

1-74. In Exhibit 1, the first category of liabilities is ________ liabilities. As you might expect from the discussion of current assets, current liabilities are claims that become due within a [short / long] time, usually within ________ ________ (how long?).

current

short

one year

1-75. As we have seen, Garsden Company has obtained funds by borrowing, and $________ of this debt is not due to be repaid until after December 31, ________. This amount is therefore a [current / noncurrent] liability.

$2,000,000

2010

noncurrent

1-76. Liabilities are claims against all the assets. The $5,602,000 of accounts payable on the Garsden Company balance sheet is a claim against [the current assets of $22,651,000 / the total assets of $38,239,000].

the total assets of $38,239,000

CURRENT RATIO

1-77. The current assets and current liabilities indicate the entity's ability to meet its current obligations. A measure of this ability is the **current ratio,** which is the ratio of **current** assets to **current** liabilities. For Garsden Company, the current ratio is:

$$\frac{\text{current assets}}{\text{current liabilities}} = \frac{\boxed{\$\qquad\qquad}}{\boxed{\$\qquad\qquad}} = \boxed{\qquad *} \text{ to } 1$$

* Carry this amount to one decimal place.

$$\frac{\$22{,}651{,}000}{\$\ 9{,}519{,}000} = 2.4 \text{ to } 1$$

1-78. In Garsden's industry, a current ratio of at least 2 to 1 is desirable. Garsden Company [does / does not] pass this test.

does

EQUITY

1-79. Equity consists of capital obtained from sources that are not liabilities. As Exhibit 1 indicates, there are two sources of equity capital: (1) \$12,256,000, which is labeled Total ____________ - ______ ____________ and (2) \$13,640,000, which is labeled ____________ ____________.

Paid-in
Capital Retained
Earnings

1-80. Paid-in capital is the amount of capital supplied by equity investors. They own the entity. The details of how this item is reported depends on the type of organization. Garsden Company is a corporation, and its owners receive *shares* of common ____________ as evidence of their ownership. They are therefore called s _ _ _ _ _ holders. Other forms of ownership will be described in Part 8.

stock
share (or stockholders)

1-81. The paid-in capital is reported as two separate amounts: \$1,000,000, which is labeled ____________ ____________, and \$11,256,000, labeled Additional ________ - ______ ____________. The reasons for this distinction are described in Part 8. The important number is the total amount paid in by the shareholders, which is \$____________.

Common Stock
Paid-in Capital

\$12,256,000

1-82. Individual shareholders may sell their stock to someone else, but this has no effect on the balance sheet of the corporation. The market price of shares of Apple, Inc. stock changes almost every day; the amount of paid-in capital reported on the Apple, Inc. balance sheet [does / does not] reflect these changes. This is consistent with the e _ _ _ _ _ _ concept; transactions between individual shareholders do not affect the entity.

does not
entity

1-83. The other equity item, \$13,640,000, shows the amount of equity that has been *earned* by the profitable operations of the company and that has been *retained* in the entity; hence the name, R _ _ _ _ _ _ _ _ E _ _ _ _ _ _ _ _.

Retained
Earnings

1-84. **Retained earnings** represents those amounts that have been retained in the entity after part of the company's earnings (i.e., profits) have been paid to shareholders in the form of dividends. Complete the following equation:

Retained Earnings = [ ] − [ ].

Earnings – Dividends

1-85. Retained earnings are additions to equity that have accumulated since the entity began, not those of a single year. Therefore, unless Garsden Company has been in business only one year, the $13,640,000 shown as Retained Earnings as of December 31, 2009, reflects [one / all previous] year(s) of operations.

all previous

1-86. The amount of retained earnings shows the amount of capital generated by operating activities. It is **not** cash. Cash is an asset. On December 31, 2009, the amount of Cash was $__________. The amount of retained earnings was $__________.

$1,449,000
$13,640,000

1-87. Always keep in mind the fundamental accounting equation:

[ ] = [ ] + [ ].

Assets = Liabilities + Equity

The right-hand side of the balance sheet shows the *sources* of capital. The capital itself exists in the form of _ _ _ _ _ _, which are reported on the left-hand side.

assets

KEY POINTS TO REMEMBER

- The assets of an entity are the things of value that it owns.
- The sources of funds used to acquire assets are:
    1. liabilities and
    2. equity.
- Liabilities are sources from creditors.

- Equity consists of (1) funds obtained from equity investors, who are owners, and (2) retained earnings, which result from the entity's profitable operation.
- Creditors have a strong claim on the assets. They can sue if the amounts due them are not paid. Equity investors have only a residual claim.
- Total assets equal the total of liabilities plus equity. This is the dual-aspect concept.
- The amounts of assets, liabilities, and equity as of one point in time are reported on the entity's balance sheet.
- Accounting reports only those facts that can be stated in monetary amounts. This is the money-measurement concept.
- Business accounts are kept for entities, rather than for the persons who own, operate, or otherwise are associated with those entities. This is the entity concept.
- Accounting assumes that an entity will continue to operate indefinitely. This is the going-concern concept.
- Monetary assets are reported at their fair value; other assets are reported at a number based on cost. This is the asset-measurement concept.
- Assets are valuable items that are owned or controlled by the entity and that were acquired at a measurable cost. Goodwill is not an asset unless it was purchased.
- Current assets are cash and other assets that are expected to be converted into cash or used up in the near future, usually within one year.
- Current liabilities are obligations due in the near future, usually within one year.
- The current ratio is the ratio of current assets to current liabilities.
- Equity consists of paid-in capital (which in a corporation is represented by shares of stock) plus earnings retained since the entity began. It does not report the market value of the stock. Retained earnings is not cash; it is part of the owners' claim on the assets.

You have completed Part 1 of this program. If you think you understand the material in this part, you should now take Post-Test 1, which is found at the back of this text. If you are uncertain about your understanding, you should review Part 1.

The post-test will serve both to test your comprehension and to review the highlights of Part 1. After taking the post-test, you may find that you are unsure about certain points. You should review these points before going on to Part 2. Please review the answers to Post-Test 1, following the Post-Tests, at the back of this text.