ACCOUNTING BASICS

Chapter 1 — Practice Exercises

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How to use this: try every exercise on paper BEFORE looking at the solutions. The traps here are the same ones exams love.

Exercise 1 — Classify the business

Classify each company as service, merchandising, or manufacturing:

(a) Air Canada

(b) Best Buy

(c) BMW

(d) an accounting firm

(e) Walmart

Exercise 2 — Which GAAP rule?

Name the ground rule each scenario violates or applies:

(a) The owner pays his family's groceries from the business bank account.

(b) Land bought for $100,000 is worth $300,000 ten years later — the books still say $100,000.

(c) A company wants to record its 'excellent reputation' as an asset.

(d) A company reports its Apple shares at today's market price.

Exercise 3 — Solve the equation

Fill in the missing number:

(a) Assets $95,000 · Liabilities $32,000 · Owner's equity = ?

(b) Liabilities $18,500 · Owner's equity $41,200 · Assets = ?

(c) Assets $26,400 · Owner's equity $21,200 · Liabilities = ?

Exercise 4 — Transaction analysis

For each transaction of XYZ Tutoring, state the effect on assets, liabilities, and owner's equity (with amounts):

1. Owner invests $9,000 cash
2. Buys a laptop for $1,500 cash
3. Tutors a client on account, $600
4. Pays office rent, $800
5. Collects the $600 from transaction 3
6. Owner withdraws $300
7. Buys $200 of supplies on account

Exercise 5 — True or false (the traps)

(a) Borrowing cash from a bank increases revenue.

(b) Collecting an account receivable increases revenue.

(c) Owner withdrawals are an expense of the business.

(d) Revenue can be earned before any cash is received.

(e) Every transaction affects at least two accounts.

Exercise 6 — Prepare the statements

XYZ Tutoring's first year: service revenue $48,000 · salaries expense $21,000 · rent expense $9,600 · utilities expense $2,400 · owner investments $9,000 · owner drawings $4,000 · beginning capital $0 (new business).

(a) Prepare the income statement.

(b) Prepare the owner's equity statement.

(c) Explain WHY the statements must be prepared in this order.

Exercise 7 — Identify, Record, or Communicate?

Nova Design Studio performs the tasks below. Label each as Identification (I), Recording (R), or Communication (C):

(a) Deciding whether a client's verbal promise of future work counts as a recordable event

(b) Entering the week's sales in the books

(c) Preparing the annual income statement

(d) Analyzing whether rising rent is squeezing profit

(e) Sorting and journalizing the month's receipts

(f) Spotting that a newly signed equipment lease changes the company's assets

Exercise 8 — Internal or external user?

(a) Label each user of Harbor Dry Cleaning's financial information as internal (I) or external (E):

production supervisor

bank loan officer

tax authority

marketing manager

supplier deciding whether to extend credit

labor union

chief financial officer

(b) Who would most likely ask each question — an internal or an external user?

1. Can we afford to give the team a raise this year?
2. Will the company be able to pay its short-term debts?
3. Which service should we advertise more heavily?
4. Did the company earn enough income to justify buying its shares?

Exercise 9 — Correct or violation? Name the principle

(a) A company records its new delivery van at the $23,500 it actually negotiated and paid, not the $27,000 sticker price.

(b) The owner routes the family's vacation flights through the business account as 'travel expense.'

(c) A company adds a line to its balance sheet: 'Talented engineering team — $500,000.'

Exercise 10 — The ethics case

Lena, president of Marlow Landscaping, tells the bookkeeper: 'Report our land at its appraised value of $140,000 instead of the $80,000 we paid — the balance sheet will look much stronger when we ask the bank for a loan.'

(a) Is this acceptable under GAAP? Which principle applies — and why doesn't fair value rescue it?

(b) Who is harmed if the bookkeeper obeys?

Exercise 11 — Classify the balance sheet items

Harbor Dry Cleaning has the items below. Classify each as an asset (A), a liability (L), or owner's equity (OE):

- cash
- accounts receivable
- supplies
- equipment
- accounts payable
- notes payable
- salaries and wages payable
- unearned service revenue
- owner's capital

Exercise 12 — Effects on the equation

For each transaction of GreenThumb Garden Services, state the effect on total assets, total liabilities, and owner's equity (increase, decrease, or no effect):

1. Owner invests cash to start the business
2. Pays the monthly rent
3. Buys a mower on account
4. Bills a client for a completed job
5. Collects the amount billed in transaction 4
6. Owner withdraws cash for personal use
7. Pays half of the amount owed from transaction 3
8. Receives this month's utility bill, to be paid next month

Exercise 13 — THE CAPSTONE: tabular analysis + all three statements

Rana opened Skyline Architecture Studio some time ago. On **February 28**, the studio's balance sheet showed:

Cash	Accounts Receivable	Supplies	Equipment	Accounts Payable	Owner's Capital
$6,200	$2,400	$800	$9,000	$3,600	$14,800

During **March**, these transactions occurred:

1. Paid staff salaries $3,100, office rent $1,200, and advertising $350 — all in cash.
2. Purchased additional equipment for $2,600, paying $600 in cash and the balance on account.
3. Collected $1,800 of accounts receivable.
4. Borrowed $3,500 from Cedar Bank on a note payable.
5. Recognized design revenue of $9,200 — $4,000 collected in cash, the remainder due in April.
6. Received the month's utility bill, $320, to be paid in April.
7. Paid $2,200 cash on accounts payable.
8. Rana withdrew $900 cash for personal use.

Instructions

(a) Prepare a tabular analysis of the March transactions, beginning with the February 28 balances. Column headings: Cash + Accounts Receivable + Supplies + Equipment = Notes Payable + Accounts Payable + Owner's Capital – Owner's Drawings + Revenues – Expenses.

(b) Prepare an income statement and an owner's equity statement for March, and a balance sheet at March 31.

SOLUTIONS

Solution 1

(a) Air Canada — **service** (sells transportation, a service)
(b) Best Buy — **merchandising** (sells products made by others)
(c) BMW — **manufacturing** (makes what it sells)
(d) accounting firm — **service**
(e) Walmart — **merchandising**

Solution 2

(a) **Violates the economic entity assumption** — two wallets, never mixed.
(b) **Applies the cost concept** — record at purchase price, based on objective evidence.
(c) **Violates the monetary unit assumption** — reputation can't be expressed in dollars.
(d) **Applies the fair value principle** — the market price of traded shares is easy to find.

Solution 3

(a) Owner's equity = 95,000 – 32,000 = **$63,000**
(b) Assets = 18,500 + 41,200 = **$59,700**
(c) Liabilities = 26,400 – 21,200 = **$5,200**

Solution 4

#	Effect	Why
1	Cash +9,000 · Capital +9,000	money into the business pocket; the owner's claim rises
2	Laptop +1,500 · Cash –1,500	asset swap — total assets unchanged
3	A/R +600 · Revenue +600	earned when the work is done; the IOU is an asset
4	Cash –800 · Rent expense +800 (equity down)	nothing left to keep — the space is consumed
5	Cash +600 · A/R –600	swap: paper promise for cash — NO new revenue
6	Cash –300 · Drawings +300 (equity down)	pocket-to-pocket; not a business cost, never an expense
7	Supplies +200 · A/P +200	own the supplies now; the promise to pay is a liability

Solution 5

(a) **False** — a loan must go back; it's a liability, never revenue.
(b) **False** — the revenue was recorded when earned; collecting swaps A/R for cash.
(c) **False** — drawings cut equity directly; they never touch net income.
(d) **True** — revenue is recognized when the service is performed.
(e) **True** — that's double-entry accounting.

Solution 6

(a) **Income statement:** service revenue 48,000 – total expenses 33,000 (salaries 21,000 + rent 9,600 + utilities 2,400) = **net income $15,000**.

(b) **Owner's equity statement:** beginning capital 0 + investments 9,000 + net income 15,000 – drawings 4,000 = **ending capital $20,000**.

(c) The income statement comes first because it produces net income — the number the owner's equity statement needs. Each statement hands a number to the next, like runners passing a baton. Traps: the $9,000 investment is NOT revenue, and the $4,000 drawings are NOT an expense — neither appears on the income statement.

Solution 7

(a) **I** — judging whether an event is recordable is identification.

(b) **R**

(c) **C** — statements are the communication step.

(d) **C** — analysis and interpretation belong to communication.

(e) **R**

(f) **I** — spotting that an event changes assets is identification.

Solution 8

(a) Internal: production supervisor, marketing manager, CFO. External: bank loan officer, tax authority, supplier, labor union.

(b) 1 — internal (management decision) · 2 — external (creditor's question) · 3 — internal (operating decision) · 4 — external (investor's question)

Solution 9

(a) **Correct** — the cost concept: record at the actual purchase price, objective evidence.

(b) **Violation** of the economic entity assumption — personal costs are not the business's problem.

(c) **Violation** of the monetary unit assumption — talent cannot be objectively expressed in dollars, however real it is.

Solution 10

(a) **Not acceptable.** The cost concept requires land to stay at its $80,000 purchase price — cost is based on objective evidence, a real receipt, not an appraisal. Fair value doesn't rescue it: fair value is reserved for items whose market price is easy to find, like traded securities — land has no price tag hanging on it. (b) The bank is harmed most: it would lend against inflated numbers. Ultimately the business is harmed too — statements that can't be trusted make every future reader discount everything the company reports.

Solution 11

Assets: cash, accounts receivable, supplies, equipment

Liabilities: accounts payable, notes payable, salaries and wages payable, unearned service revenue (you owe the customer WORK — a debt payable in service instead of dollars)

Owner's equity: owner's capital

Solution 12

#	Assets	Liabilities	Owner's equity	Why
1	increase	no effect	increase	cash in; the owner's claim rises
2	decrease	no effect	decrease	rent expense — nothing left to keep
3	increase	increase	no effect	mower arrives; promise to pay is born
4	increase	no effect	increase	A/R up; revenue earned when the job is DONE
5	no effect	no effect	no effect	swap: A/R becomes cash — no new revenue
6	decrease	no effect	decrease	drawings — pocket to pocket, not an expense
7	decrease	decrease	no effect	settling old business, not a new cost
8	no effect	increase	decrease	utility expense already incurred; unpaid bill = liability

Solution 13 — step by step

(a) Tabular analysis. Start from the February 28 balances, apply each transaction on its own row, and check that the equation balances after EVERY row:

	Cash	A/R	Suppl.	Equip.	=	N/P	A/P	Capital	– Draw.	+ Rev.	– Exp.
Feb 28	6,200	2,400	800	9,000		—	3,600	14,800	—	—	—
1	–4,650										+4,650
2	–600			+2,600			+2,000				
3	+1,800	–1,800									
4	+3,500					+3,500					
5	+4,000	+5,200								+9,200	
6							+320				+320
7	–2,200						–2,200				
8	–900								+900		
Mar 31	7,150	5,800	800	11,600		3,500	3,720	14,800	900	9,200	4,970

Row-by-row logic:

1. Three expenses paid in cash: 3,100 + 1,200 + 350 = 4,650. Cash down; expenses up (equity down).
2. Equipment +2,600 but only 600 cash left the pocket — the other 2,000 is a promise to pay (A/P up).
3. Swap: the customer's IOU becomes cash. A/R down 1,800, cash up 1,800 — NO new revenue.
4. Loan: cash up 3,500 with a string attached — Notes Payable up 3,500. Never revenue.
5. Revenue 9,200 earned NOW (work done): 4,000 arrives as cash, 5,200 becomes A/R.
6. The utilities were already used — expense NOW, even though cash moves in April (A/P up 320).
7. Paying old debts: cash down 2,200, A/P down 2,200. Equity feels nothing.
8. Drawings 900: business pocket to personal pocket — never an expense.

Balance check: assets 7,150 + 5,800 + 800 + 11,600 = **$25,350** · right side 3,500 + 3,720 + 14,800 – 900 + 9,200 – 4,970 = **$25,350** ✓

(b) The three statements, in order. Remember the video's rule: every statement carries three lines at the top — the name of the company, the name of the paper, and the appropriate date or period.

Step 1 — Income statement (covers a PERIOD of time):

SKYLINE ARCHITECTURE STUDIO
Income Statement
For the Month Ended March 31

Revenues		
Design revenue		$9,200
Expenses		
Salaries expense	$3,100	
Rent expense	1,200	
Advertising expense	350	

Utilities expense	320	
Total expenses		4,970
Net income		$4,230

Step 2 — Owner's equity statement (net income sprints over from step 1):

SKYLINE ARCHITECTURE STUDIO
Owner's Equity Statement
For the Month Ended March 31

Owner's capital, March 1	$14,800
Add: Net income	4,230
	19,030
Less: Drawings	900
Owner's capital, March 31	$18,130

Step 3 — Balance sheet (a specific DATE — a snapshot). The video showed it drawn two ways; here are both:

Account format — assets on the left, liabilities and equity on the right, side by side:

SKYLINE ARCHITECTURE STUDIO
Balance Sheet (account format)
March 31

ASSETS		LIABILITIES & OWNER'S EQUITY	
Cash	$7,150	Liabilities	
Accounts receivable	5,800	Notes payable	$3,500
Supplies	800	Accounts payable	3,720
Equipment	11,600	Total liabilities	7,220
		Owner's equity	
		Owner's capital	18,130
Total assets	$25,350	Total liabilities & owner's equity	$25,350

Report format — same information, stacked top to bottom:

SKYLINE ARCHITECTURE STUDIO
Balance Sheet (report format)
March 31

Assets	
Cash	$7,150
Accounts receivable	5,800
Supplies	800
Equipment	11,600
Total assets	$25,350
Liabilities	

Notes payable	$3,500
Accounts payable	3,720
Total liabilities	7,220
Owner's equity	
Owner's capital	18,130
Total liabilities & owner's equity	$25,350

Both sides read $25,350 — the accounting equation, printed on paper. Traps recap: the loan (4) and the collection (3) are never revenue; the utility bill (6) is an expense before any cash moves; the withdrawal (8) is drawings, not an expense.

Scored below 11/13? Rewatch the transaction analysis section of the Chapter 1 video. Got them all? Chapter 2 is waiting — where you'll learn what DEBIT actually means.