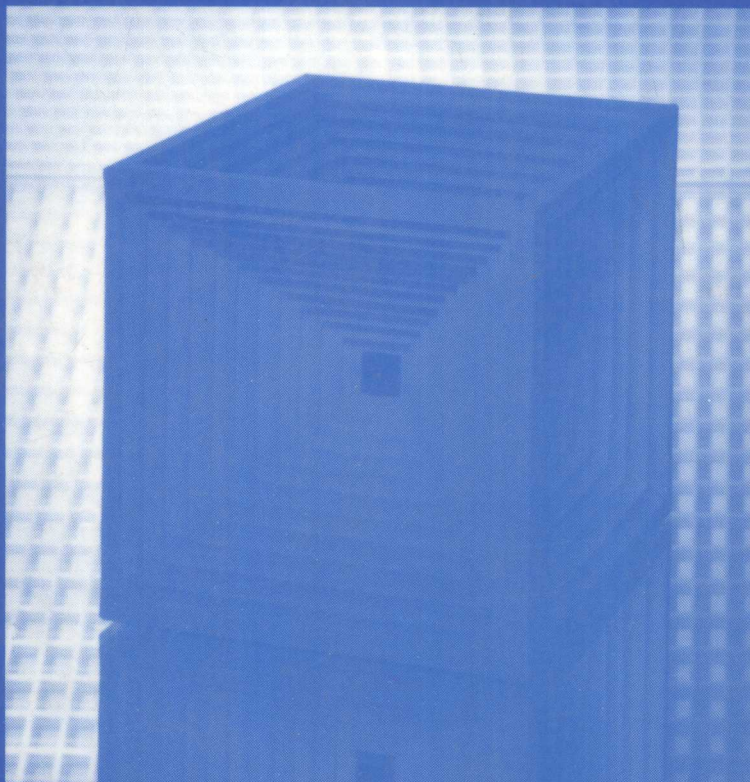


VOLUME I

Study Guide Chapters 1-14 for use with

Accounting Principles

Fourth Edition



Prepared by Gayle Rayburn
and the Authors of Accounting Principles

Hermanson ■ Edwards ■ Salmonson

Study Guide

Volume I (Chapters 1-14)

for use with

Accounting Principles

Fourth Edition

Hermanson, Edwards, and Salmonson

**Prepared by L. Gayle Rayburn
and the Authors of Accounting Principles**

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Note To Student

This Study Guide has been prepared to assist you in performing well in the accounting course you are taking. For each chapter the Study Guide contains:

- Learning Objectives
- Reference Outline
- Chapter Review
- Demonstration Problem
- Solution to Demonstration Problem
- Matching Question
- Completion Questions and Exercises
- True-False Questions
- Multiple Choice Questions
- Business Situation for Discussion
- Solutions to all questions and exercises

We looked at our competitor's products and attempted to prepare the most comprehensive, student-oriented Study Guide in existence. We hope you agree that we succeeded.

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Introduction: The Accounting Environment

LEARNING OBJECTIVES

1. Define accounting.
 2. Describe the functions performed by accountants.
 3. Describe employment opportunities in accounting.
 4. Differentiate between financial and managerial accounting.
 5. Identify the five organizations that have a role in the development of financial accounting standards.
-

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REVIEW OF INTRODUCTION

Learning Objective 1:
Define accounting.

ACCOUNTING DEFINED

1. Accounting is defined as "the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information."¹

Learning Objective 2:
Describe the functions performed by accountants.

2. Accountants observe many events and identify and measure in financial terms those events considered evidence of economic activity. The economic events are recorded, classified into meaningful groups, and summarized for conciseness. Accountants report on business activity by preparing financial statements and special reports.

Learning Objective 3:
Describe employment opportunities in accounting.

EMPLOYMENT OPPORTUNITIES IN ACCOUNTING

3. Accounting is now recognized as an important profession and offers various types of employment.

PUBLIC ACCOUNTING

4. The public accounting profession offers accounting and related services for a fee to companies, other organizations, and the general public.
 - a. An accountant may become a certified public accountant (CPA) by passing an examination and meeting other requirements.
 - b. Some CPAs are hired as auditors by companies to conduct an examination of their accounting and related records.
 - c. Auditors give independent opinions or reports indicating whether the financial statements fairly report the economic performance of the business.

- d. CPAs also often provide expert advice on the preparation of federal, state, and city tax returns as well as on tax planning.
- e. Management advisory or consulting services are also performed by CPAs to provide clients with suggestions on how to improve their operations.

PRIVATE (OR INDUSTRIAL) ACCOUNTING

5. Private or industrial accountants provide services for one business; they may or may not be CPAs.
 - a. Some private accountants, regardless of whether they are CPAs or not, pass the Certified Management Accounting (CMA) exam.
 - b. Some private accountants conduct internal audits to determine if policies and procedures established by the business are being followed; these accountants may pass the Certified Internal Auditors (CIA) exam.

GOVERNMENTAL AND OTHER NOT-FOR-PROFIT ACCOUNTING

6. Other accountants, having similar educational background and training, may be employed by governmental agencies and academic institutions.

Learning Objective 4:
Differentiate between financial and managerial accounting.

FINANCIAL ACCOUNTING VERSUS MANAGERIAL ACCOUNTING

7. Accounting is divided into two categories, financial and managerial accounting, based on the parties for whom the information is prepared.

FINANCIAL ACCOUNTING

8. Financial accounting information is prepared for external users such as stockholders and creditors.

¹American Accounting Association, *A Statement of Basic Accounting Theory* (Evanston, Ill., 1966), p. 1.

MANAGERIAL ACCOUNTING

9. Managerial accounting provides special information for the managers of a company ranging from broad, long-range plans to detailed explanations.
10. Managerial accounting focuses on the parts of the company, while financial accounting information relates to the company as a whole.

Learning Objective 5:

Identify the five organizations that have a role in the development of financial accounting standards.

THE DEVELOPMENT OF FINANCIAL ACCOUNTING STANDARDS

11. These five organizations—the American Institute of Certified Public Accountants, Financial Accounting Standards Board, Governmental Accounting Standards Board, Securities and Exchange Commission, and the American Accounting Association—have each contributed to the development of Generally Accepted Accounting Principles (GAAP).

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

12. The AICPA Committee on Accounting Procedures issued *Accounting Research Bulletins* recommending certain principles or practices during a 20-year period ending in 1959.
13. The Committee's successor, the Accounting Principles Board (APB), issued *Opinions* which CPAs generally are required to follow.
14. Through its monthly magazine, the *Journal of Accountancy*, the AICPA continues to influence the development of accounting standards and practices.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

15. The Financial Accounting Standards Board replaced the Accounting Principles Board in 1973.
16. The FASB is an independent, seven-member, full-time board which has issued numerous *Statements of Financial Accounting Standards*.

GOVERNMENTAL ACCOUNTING STANDARDS BOARD (GASB)

17. The Governmental Accounting Standards Board was established in 1984.
18. This organization is the major influence in the private sector in the development of new governmental accounting concepts and standards.

SECURITIES AND EXCHANGE COMMISSION (SEC)

19. The SEC has the power to prescribe accounting practices to be followed by companies under its jurisdiction.
20. The SEC also indicates to the FASB the accounting topics it believes should be addressed and works closely with the accounting profession.

AMERICAN ACCOUNTING ASSOCIATION (AAA)

21. The American Accounting Association is composed largely of accounting educators and has sought to encourage research and study into the concepts, standards and principles of accounting on a theoretical level.

COMPLETION QUESTIONS

1. Accounting is primarily an information system with three objectives—to _____, _____, and _____ economic information that is relevant to users for their decision-making needs.

2. The three major employment fields in accounting are _____ , _____ , and _____ .
3. Financial accounting information generally relates to a company as a _____ and is usually _____ in nature.
4. Accounting deals primarily with information regarding _____ activities of a business and is expressed in _____ terms.
5. Accountants who offer their services solely to a single profit-seeking organization are said to be in _____ or _____ accounting.
6. An independent, professional accountant, licensed by the state to practice as a certified public accountant (CPA), may offer clients three types of services, namely, _____ , _____ , and _____ services.
7. The decisions that must be made by the management of a business generally fall into four major categories: (a) _____ , (b) _____ , (c) _____ , and (d) _____ decisions. That part of the accounting discipline called upon to provide information for such internal decision making is called _____ accounting.
8. The two tests that information supplied by managerial accountants must meet are:
 1. _____
 2. _____
9. The dominant influence over the past half century in the development of financial accounting standards is the _____ .
10. A governmental agency having the power to prescribe the accounting practices of most large business corporations is the _____ .
11. The major influence in the private sector in the development of new governmental accounting concepts and standards is the _____ .
12. An accountant's most valuable asset is his or her _____ .

BUSINESS SITUATION FOR DISCUSSION

The Profession Revises its Code*

by Virginia P. Leonhardt, CPA
and Don-Tomis Leonhardt, CPA, CIA

If you're planning to become a certified public accountant, you are getting ready to enter a vocation long ranked as one of the most ethical. However, attitude surveys reflect a growing sense of a decline in business ethics, including those of CPAs.

A recent Touche Ross survey of more than a thousand top business, education and congressional leaders disclosed that, "Ninety-four percent say the business community is troubled by ethical problems today."

This attitude is especially troublesome to the accounting profession whose services require in-

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tegrity, objectivity and independence—both in fact and appearance. In order to combat the perception of declining ethics, as well as address the expanding scope of services, the American Institute of Certified Public Accountants (AICPA) this year voted to rewrite its Professional Code of Ethics. Let's take a look at how the code evolved and the impact its revisions will have on tomorrow's CPAs.

In the Beginning. The need for audits of publicly-held corporations by an independent, competent and candid party helped found the CPA profession. Prior to the industrial revolution, company managers were frequently also the owners. As public ownership of corporations grew through stock issuance, so did the number of owners who were not privy to detailed information about the company's operations. Investors needed assurance that management-prepared financial statements were realistic. By attesting to the fairness of financial statement presentation, CPAs bridged this gap between corporate managers and investors.

Of course, for this attest function to have value, investors must have confidence in the integrity and competence of CPAs. Realizing the importance of this trust, the CPA profession instituted a code of ethics for its members in performing audits.

Over the decades the code has experienced occasional updates and revisions to accommodate changing times. The just-revised code evolved from a 1967 project to study ethics issues; the resultant amendments were approved by the AICPA membership in 1973.

The Code's Structure. The code had been organized into five sections: Independence, Integrity and Objectivity; General and Technical Standards; Responsibilities to Clients; Responsibilities to Colleagues; Other Responsibilities and Practices. Additionally, the code defined each section in terms of its Concepts, Rules, Interpretations and Rulings. The Concepts stated ideological qualities for practicing accountants; these were not meant to be enforceable procedures. The Rules of Conduct defined expected behavior, serving as the basis for disciplinary action. Any member whose actions infringed upon an established Rule was subject to reprimand, suspension or expulsion by the AICPA's Trial Board. The Interpretations clarified the scope and application of a Rule, while the Rulings illustrated particular situations.

In summary, the Rules documented enforceable standards, covering a gamut of professional activ-

ities by code section. The first section stressed auditor independence and impartiality, both in fact and appearance. The second section specified standards regarding auditor competence. Included here were requirements that auditors exercise due professional care, plan and properly supervise the audit, and gather sufficient relevant data as a basis for conclusions. The third section outlined the responsibility to maintain client confidentiality and prohibited the charging of contingent fees for any professional service. Originally intended to prohibit cut-throat competition among CPAs, the fourth section reserved discussion for responsibilities to colleagues. Finally, the fifth section specified a potpourri of other rules prohibiting the auditor from advertising, paying or accepting commissions, maintaining incompatible occupations while auditing and using fictitious firm names. These rules generally addressed public accounting practice (e.g., audit, tax, advisory service). Those members not in public practice were required to follow only two Rules: to maintain both integrity and objectivity and to avoid discreditable acts.

Over the past two decades, the profession has been scrutinized, both publicly and privately. During the 1970's certain governmental agencies challenged various rules in the code. The U.S. Department of Justice, aiming to increase competition, threatened the CPA profession with antitrust action. Under this pressure, the AICPA amended the code to permit conventional forms of advertising and solicitation.

FTC Request Rejected. The Federal Trade Commission (FTC) reopened investigations in 1985 to determine whether the code of ethics unreasonably restricted trade, through its limitation on commissions and contingent fee structures. Discussion on this topic is still taking place following the AICPA's rejection of the FTC's 1987 request to allow members' use of commissions, contingent fees, referral payments and other prohibited acts.

Two other committees also convened hearings on the accounting profession during 1985. The House Government Operations Committee reviewed accounting and auditing procedures regarding federal grant funding and in 1986 recommended increased training, disciplinary sanctions and peer reviews to improve audit quality. The Oversight and Investigations Subcommittee was formed to determine the effectiveness of CPAs' auditing publicly owned corporations as well as the performance of the Securities and Exchange

Commission. This ongoing examination continues into 1988, with particular attention focused on fraudulent reporting and auditor responsibility.

In addition to governmental scrutiny, pressure grew within the profession to amend the code of ethics. New types of business services were evolving that were well-suited to CPAs' abilities, including: analyzing, designing and implementing management information systems, performing executive employee searches, preparing special reports such as budgets, forecasts and personal financial plans, as well as acting in the capacity of a general business adviser. The code of ethics, being audit-oriented, restricted CPAs from performing these non-audit functions due to a potential lack of independence. CPAs could not compete for these services against providers who were not restricted by a similar code. As new practice areas were explored, the existing code of ethics lost its significance to many in the profession.

Into the Courtrooms. These years also ushered in the era of litigations, and the CPA profession was not immune. While substandard audit work resulting in failure to detect materially misleading financial statements occurred in only a small fraction of cases, it did occasionally lead to major financial losses and alarming headlines. Even when appropriate audit techniques were employed, accusing fingers often pointed to auditors following a business failure. Because these events bruised the image of the accounting profession and threatened intrusive governmental regulation, the AICPA responded by looking into strengthening the profession through its ethics code.

Restructured Standards. In 1983 the AICPA organized a special committee, headed by former AICPA Chairman George D. Anderson, to evaluate "the relevance of the existing ethical standards to professionalism, integrity and the commitment to quality service and the public interest." The committee's findings, which became known as the "plan to restructure," offered proposals for improving professional quality in three general areas: 1) code of ethics, 2) quality monitoring and 3) education. These proposals led to a new code of ethics and changes to the AICPA's bylaws, which were passed by more than a two-thirds majority membership vote in January 1988.

The new code applies to all AICPA members, not just those in public practice. The most important change is a shift in emphasis from rules prohibit-

ing unacceptable behavior to goals urging optimal behavior.

The Rules of Performance and Behavior contain enforceable rules similar to those in the old code; however, revisions have been made to accommodate situations relevant to non-traditional services—notably, contingent fees, commissions and incompatible occupations.

The prior code banned contingent fees, i.e., variable fees dependent upon a particular outcome. In audit situations contingent fees could compromise auditor independence if, for instance, the audit fee was based on a percentage of client net income. However, many of the new non-audit services offered by CPAs, such as investment advising, are ideally suited for contingent fee billing. The new code allows contingent fee arrangements, but stipulates that auditor independence would be sacrificed under such arrangements. Similarly, receipt or payment of a commission to refer or obtain business would likewise impair an auditor's objectivity and independence.

Because many CPAs now offer substantial management advisory services, such as computer consulting, the new code eliminated the specific rule prohibiting a CPA from engaging in an incompatible occupation while performing audit services. The intention of the former rule was to avoid conflict of interest situations where, for example, a CPA designs and implements a client's computer system and subsequently audits the same system. The auditor might hesitate noting internal control weaknesses in a system he or she designed. Rather than specifically restrict management consulting services, the code now addresses the underlying condition of conflict of interests and its relationship to the standard of objectivity.

Quality Review. For a code of ethics to be effective it must be abided by and enforced. To ensure this, the AICPA also voted for programs of mandatory quality review and ethics enforcement. The quality review program requires AICPA members in public practice to undergo periodic reviews of their work. The reviews are to be administered jointly by the institute and the state societies and conducted by teams of CPAs. The emphasis of the program is not to punish, but to help individual practitioners improve their practice. Disciplinary action will be levied only as final recourse for failure to cooperate or for continually deficient work. In addition to the quality review program, a new

nationwide ethics enforcement system will replace the regional structure to provide impartial resolutions of complaints against CPAs.

Tougher Requirements. Three resolutions regarding education will affect current and future practitioners. While CPAs in public practice must pursue annual continuing professional education (CPE) in order to satisfy state licensure requirements, those in private industry, government, education and other areas do not. Since all who represent themselves as CPAs should remain current in their field regardless of employment, the Institute's membership approved one proposal mandating CPE for CPAs not in public practice and another formalizing CPE requirements for practicing CPAs.

The final proposal involved a CPA's basic education requirement. After the year 2000, prospective members will need 150 hours of college education (five years), including a bachelor's degree.

* * * * *

The CPA profession reached prominence thanks to its commitment to integrity and public service. Society looks toward the CPA profession to provide attest and other financial services with a high level of professionalism. Armed with a revamped Code of Professional Ethics, quality controls and increased educational requirements, CPAs aim to realize their centennial theme: "For excellence in our second century."

SOLUTIONS

Completion

1. identify; measure; communicate
2. public accounting; private accounting; governmental and other not-for-profit accounting
3. whole; historical
4. economic; monetary
5. private or industrial
6. auditing; management advisory; tax
7. (a) financial (b) resource allocation; (c) production; (d) marketing; managerial
8. 1. It must be useful.
2. It must not cost more to gather than it is worth (this is known as the cost/benefit test).
9. American Institute of Certified Public Accountants
10. Securities and Exchange Commission
11. Governmental Accounting Standards Board
12. reputation

1

Accounting and Its Use in Business Decisions

LEARNING OBJECTIVES

1. Identify and describe the three basic forms of business organizations.
2. Distinguish between the three types of business activities performed by business organizations.
3. Describe the content and purposes of the income statement, statement of owner's equity, and balance sheet.
4. State the basic accounting equation and describe its relationship to the balance sheet.
5. Analyze business transactions and determine their effects on items in the financial statements.
6. Prepare an income statement, a statement of owner's equity, and a balance sheet.

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CHAPTER REVIEW

Learning Objective 1:

Identify and describe the three basic forms of business organizations.

FORMS OF BUSINESS ORGANIZATIONS

1. A business organization is referred to as an accounting or business entity; the three basic forms of business organizations regarding ownership are single proprietorship, partnership, and corporation.

SINGLE PROPRIETORSHIP

2. A single proprietorship is a business owned by one individual.
 - a. This business is often managed by the owner.
 - b. There are no legal formalities in organizing a single proprietorship and usually only a limited investment is required to begin operations.
 - c. In a single proprietorship, the owner is solely responsible for all debts of the business.
 - d. The business is considered an entity separate from the owner.

PARTNERSHIP

3. A business owned by two or more persons associated as partners is a partnership.
 - a. Partners often manage the business.
 - b. A partnership agreement creates the partnership and sets forth the terms of the business.
 1. The partnership agreement itemizes the duties of each partner, initial investment of each partner, and means of dividing profits or losses among partners.
 2. A written partnership agreement is preferred over an oral agreement.
 - c. Each partner may be held liable for all the debts of the partnership.

CORPORATION

4. A corporation may be owned by a varying number of persons and is incorporated under the laws of a state.
 - a. Owners of the corporation are called stockholders or shareholders.
 - b. Stockholders elect a board of directors which then selects officers who manage the corporation.

Learning Objective 2:

Distinguish between the three types of business activities performed by business organizations.

TYPES OF BUSINESS ACTIVITIES PERFORMED BY BUSINESS ORGANIZATIONS

5. Instead of classifying business entities according to the type of ownership, they can be grouped according to the type of business activities they perform—service companies, merchandising companies, and manufacturing companies.
 - a. Service companies perform such services as accounting, cleaning, and legal work for a fee.
 - b. Merchandising companies buy goods that are ready for sale and sell them directly to customers.
 - c. Manufacturing companies purchase materials and convert them into a different product for sale to other companies or to final customers.

Learning Objective 3:

Describe the content and purposes of the income statement, statement of owner's equity, and balance sheet.

FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES

THE INCOME STATEMENT

6. The income statement reports the profitability of a business organization for a stated period of time.

- a. An income statement may be called an earnings statement.
- b. An income statement indicates the revenues earned and the expenses incurred, and shows the difference, which is net income (if revenues exceed expenses) or net loss (if expenses exceed revenues).
 1. Revenues are defined as the inflow of assets resulting from the sale of products or the rendering of services to customers.
 2. Expenses are the costs incurred to produce revenues.

THE STATEMENT OF OWNER'S EQUITY

7. The statement of owner's equity connects the income statement and the balance sheet; it shows the changes that occurred in the owner's capital balance between two points in time.
 - a. Additional owner investments and net income are added to the beginning owner's capital balance.
 - b. Owner withdrawals (drawings) and net losses are deducted.

THE BALANCE SHEET

8. The balance sheet reflects the organization's solvency. Solvency is the ability to pay debts as they become due.
9. A balance sheet lists the firm's assets, liabilities, and owner's equity at a specific moment in time.
10. A balance sheet is sometimes called the statement of financial position.

ASSETS

11. Assets are things of value owned by the business.
12. Assets are known as resources and include such items as cash, land, and buildings.

LIABILITIES

13. Liabilities are debts owed by a firm and usually must be paid by a specific date.

14. Liabilities include amounts owed suppliers for goods purchased with a promise to pay the amount owed at a later date.

OWNER'S EQUITY

15. Owner's equity reflects the owner's interest in the business.
16. Owner's equity is equal to assets minus liabilities.
17. Owner's equity consists of the proprietor's original investment in the business plus profits earned through operations that are not withdrawn from the business by the owner.

Learning Objective 4:

State the basic accounting equation and describe its relationship to the balance sheet.

THE FINANCIAL ACCOUNTING PROCESS

18. The process of accumulating data to include in financial statements reflects the relationship of assets, liabilities and owner's equity.

THE ACCOUNTING EQUATION

19. The accounting equation is: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$
 - a. The equation must always be in balance.
 - b. The right-hand side of the equation ($\text{Liabilities} + \text{Owner's Equity}$) reflects the equities because liabilities can be viewed as creditor's equity.
 1. Equities are interests in, or claims on, assets.
 2. The right side of the equation shows who provided the funds to acquire existing assets.

Learning Objective 5:

Analyze business transactions and determine their effects on items in the financial statements.

ANALYSIS OF TRANSACTIONS

20. Exchanges of goods and services are called transactions.
 - a. Transactions provide much of the raw data entered in an accounting process

- because an exchange is an observable event that occurred at an agreed-upon price, which is objective.
- b. The evidence of the transaction is usually a source document.
 - c. Accountants rely on five underlying assumptions or concepts.
 1. Business entity concept assumes that each business has an existence separate from its owners, creditors, employees, customers, and other parties.
 2. Money measurement concept provides a form of measurement so that economic activity is initially recorded and reported in terms of a common monetary unit of measure.
 3. Exchange-price (or cost) concept provides that most amounts are entered in an accounting system at the objective money prices determined in the exchange process.
 4. Going concern (continuity) concept allows the accountant to assume that, unless strong evidence exists to the contrary, the entity will continue indefinitely.
 5. Periodicity (time periods) concept assumes that an entity's life can be subdivided into time periods for purposes of reporting its economic activities.

TRANSACTIONS AFFECTING ONLY THE BALANCE SHEET

21. Typical transactions affecting only the balance sheet are as follows.
 - a. Owner invested cash—Increase in cash (asset) and increase in owner's capital account (owner's equity).
 - b. Borrowed money—Increase in cash (asset) and increase in loan payable account (liability).

- c. Purchased equipment (or land) for cash—Increase in equipment (or land, both are assets) and decrease in cash (asset).
- d. Purchased equipment (or land) on credit—Increase in equipment (or land, both are assets) and increase in loan payable (liability).
- e. Paid liability—Decrease in cash (asset) and decrease in accounts or loan payable (liability).

TRANSACTIONS AFFECTING THE INCOME STATEMENT AND/OR BALANCE SHEET

22. In its effort to use its assets to generate greater amounts of assets, a business typically encounters the following transactions involving revenue and expenses:
 - a. Earned service revenue and received cash—Increase in cash (asset) and increase in revenue (owner's equity).
 - b. Earned service revenue for credit—Increase in accounts receivable (asset) and increase in revenue (owner's equity).
 - c. Collected cash on accounts receivable—Increase in cash (asset) and decrease in accounts receivable (asset).
 - d. Paid for expenses such as wages or rent—Increase in expense (which decreases owner's equity) and decrease in cash (asset).
 - e. Received bill for expense incurred such as utilities—Increase in expense (which decreases owner's equity) and increase in accounts payable (liability).

SUMMARY OF TRANSACTIONS

23. The column totals in the summary of transactions are entered in the balance sheet.
24. The data in the owner's equity column are summarized and entered in the income statement.