Study Guide to accompany

Walgenbach Dittrich Hanson

FINANCIAL ACCOUNTING

An Introduction

Third Edition

Imogene A. Posey

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An Introduction

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Imogene A. Posey
The University of Tennessee

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To the Student

This Study Guide was prepared to assist you in mastering the introductory concepts in *Financial Accounting: An Introduction*, Third Edition, by Walgenbach, Dittrich, and Hanson. Thoughtful use of the Study Guide will enable you to determine how well you understand the basic ideas and procedures in the textbook.

To use the Study Guide effectively you should

1. Study each textbook chapter systematically.
2. Study carefully the chapter review given in the Study Guide. If you find statements you do not understand, review the related materials in the textbook.
3. Use the Test Your Knowledge section to check your understanding of the key concepts presented in the chapter. If your answers do not agree with those suggested in the Study Guide, reread the Study Guide review and the related textbook materials.
4. Complete the exercises in the Study Guide. These relatively simple, short exercises cover the specific concepts of the material presented in the textbook. Compare your answers with the solutions provided and review any areas requiring additional study.

Completion of the above steps should prepare you to solve the more difficult problems in the textbook. The Study Guide can also serve as a basis for a systematic review in preparation for examinations or for a general review of introductory concepts before you proceed to more advanced levels of accounting.

I would like to express my appreciation to Professor Norman E. Dittrich for his helpful suggestions and encouragement in the preparation of this Study Guide and to Professors Paul H. Walgenbach and Ernest I. Hanson for their help and encouragement and their many suggestions for improvements.

IMOGENE A. POSEY

Contents

ACCOUNTING: AN INFORMATION SYSTEM

1

CHAPTER REVIEW

1. The accounting process consists of (a) **recording,** (b) **classifying,** and (c) **summarizing** financial data in a form that serves the needs of the intended user.
2. Management may request any type of report that it finds useful for decision making; often these reports are based on historical data.
3. Most companies must file numerous tax returns for various governmental agencies, and many of these companies file special reports with appropriate regulatory agencies that may indicate rules, conditions, or definitions for the report's preparation.
4. As a result of the need for comparable comprehensive financial accounting statements for investors, creditors, and other outsiders, **generally accepted accounting principles** have evolved over the years as guidelines for accounting practices.
5. Although most accountants are employed by private business firms, performing various recording, reporting, and planning functions, others serve as independent certified public accountants or work for some branch of the government.
6. **Certified public accountants** are licensed by the state and provide services of many kinds, including independent auditing of financial statements to render an opinion on the fairness and reliability of financial reports.
7. The Certificate in Management Accounting (CMA), sponsored by the National Association of Accountants, is evidence of one's competence in accounting for management purposes.
8. The **balance sheet,** one of the basic financial statements, portrays the position of the business entity at a particular point in time by showing assets, liabilities, and owners' equity.
9. The balance sheet equation can be expressed as **Assets = Liabilities + Owners' Equity.** This equation is the basic tool for analyzing all the transactions of a business entity.
10. The **income statement** presents the results of the firm's operations over a specified period of time. Revenues and expenses incurred in earning the revenue are matched on the income statement.
11. **Net income** is determined by deducting expenses (amounts incurred for supplies and services or assets used up) from revenues (the amounts due or received from customers for services or goods provided).

12. Changes in financial position are reported for a specific period in a **statement of changes in financial position.** The sources and uses of funds, often defined as working capital, are reported in this statement. Changes in the components of the fund are also reported in the statement.
13. Activities of an organization are divided into time periods, often annual, for the preparation of accounting reports.
14. The accounting entity concept dictates that separate records be kept for distinct business units apart from their owners' personal finances and that separate financial reports be presented.
15. Accounting records are kept on a historical cost basis, less appropriate expiration; and the dollar is the monetary unit in the United States.
16. Objective evidence or estimates supported by objective analyses are important because accounting data are most useful when objective and verifiable.
17. The "going concern" concept is based on the presumption that a business firm will continue to operate indefinitely. This concept allows the accountant to assume assets will be used in the business.
18. In **accrual accounting,** revenues are recorded when goods are transferred or services are rendered, and expenses are recorded when assets are consumed or services are used.
19. It is not necessary for cash to change hands for a business to earn revenues or record expenses; the creation of an account receivable indicates an increase in assets, and the increase in liabilities or the reduction of assets can indicate the incurrence of an expense.
20. Before financial statements are prepared, accounts must be analyzed to ensure that all transactions, expiration of assets, and accruals have been recorded.
21. **Assets,** the economic resources of a business, are classified as either current (converted to cash or used up within one year of the balance sheet date) or long-term.
22. Assets initially valued at historical cost are reported at that cost less the expiration of an appropriate portion of the cost due to the use of the asset until the current date.
23. **Liabilities,** the obligations or debts of a firm, are also classified as current or long-term on the same basis as the assets.
24. The **owners' equity,** or net assets, is the difference between the assets and liabilities.
25. The owners' equity section of the balance sheet of a sole proprietorship or a partnership lists the owners' total residual interest in the firm showing no distinction between investment and earnings.
26. The owners' equity section (stockholders' equity) of a corporate balance sheet is divided into capital stock (the investment) and retained earnings (the accumulated income less dividends declared for the stockholders).
27. A corporation presents its earning per share (EPS) just below net income on its income statement.
28. **Working capital** is equal to current assets less current liabilities.
29. Ratio analysis is often used to analyze and interpret financial reports.
30. The current ratio, often used as a measure of a firm's ability to pay short-term obligations, is computed by dividing total current assets by total current liabilities.
31. Dividing stockholders' equity by total assets yields the equity ratio.
32. The return on sales is computed by dividing net income by sales.
33. Net income divided by average total assets gives the return on assets, a measure of management's utilization of the firm's assets.

CHECK YOUR KNOWLEDGE

True or False

If the following statements are generally true, circle the T; if they are generally false, circle the F.

T F 1. The use of mechanized and electronic data processing equipment has reduced the need for well-trained accountants.

T F 2. Accounting information is designed principally to serve two groups—owners and managers.

T F 3. Financial accounting of a primarily historical nature is not useful in future planning.

T F 4. To achieve various reasonable goals, business firms may keep two sets of records to satisfy different purposes (for example, one set for tax reports and another set for financial statements).

T F 5. Assets may have greater value at the balance sheet date than the reported cost figures indicate.

T F 6. Liabilities include only those obligations of a firm to creditors that can be stated in terms of money.

T F 7. Owners' equity is equal to the net assets of a business; that is, assets less liabilities.

T F 8. Revenues are recognized only when payment is received for goods and services.

T F 9. Expenses are recognized when goods or services are used or an asset expires.

T F 10. Owners' equity may be increased by net income or contributions by the owner and decreased by net loss or withdrawals.

T F 11. The statement of changes in financial position is dated as of the last day of the accounting period.

T F 12. The distribution of earnings to owners of a corporation is called a withdrawal.

Completion

Complete the following statements by writing the appropriate word or phrase in the blanks.

1. Accounting can be defined as the process of (a) ____________, (b) ____________, and (c) ____________, and ____________ the financial data of an organization.
2. The guides or standards developed over the years for imparting useful financial data are called ____________ ____________ ____________ ____________.
3. The ____________ ____________ works for a large company and assists management in determining if its financial and operating controls are effective.
4. The ____________ ____________ ____________ renders independent, expert reports on financial statements of business enterprises after an audit.
5. The ____________ ____________ portrays the financial position of an organization at a particular point in time, and the ____________ ____________ portrays the results of operations over a period of time.
6. The accounting equation may be stated as ____________ = ____________ + ____________ ____________.
7. ____________ are the economic resources of the firm that can be expressed in useful monetary terms.
8. The three principal forms of business organization are the ____________, the ____________, and the ____________ ____________.
9. The ____________ of ____________ ____________ is prepared to show the addition of net income or loss to the owners' capital as well as additional contributions or withdrawals.
10. ____________ are amounts earned during the period. They are reduced by ____________ to determine net income.
11. An owner's beginning capital was $30,000 and ending capital was $48,000. If additional contributions were $9,000 and withdrawals were $15,000, the net income for the period was $____________.
12. The presumption that a business firm will continue and will not be sold or liquidated is called the ____________ ____________ concept.
13. ____________ ____________ ____________ is presented just below the net income figure on the income statement for a corporation.
14. The ____________ ____________ is used as a measure of a firm's ability to pay short-term liabilities.
15. ____________ ____________ ____________ measures the firm's ability to generate income while employing an average amount of assets.
16. The statement of changes in financial position portrays the ____________ of operating funds, the ____________ of operating funds, and the ____________ ____________ ____________ of those funds.
17. ____________ ____________ is the excess of current assets over current liabilities.

EXERCISES

1-1. Prepare a comparative balance sheet for Nathan Appliance Repair, Inc., on December 31, 19X1 and 19X2, using the following list of accounts:

	19X2	19X1
Accounts Payable	$10,200	$8,400
Accounts Receivable	4,800	3,800
Accumulated Depreciation—Equipment	2,500	2,000
Accumulated Depreciation—Delivery Truck	2,500	1,500
Cash	6,200	5,700
Capital Stock, $10 par value	5,000	5,000
Delivery Truck	$8,500	$8,500
Equipment	6,000	6,000
Notes Payable (due in 90 days)	1,500	2,000
Notes Payable (due on March 15, 19X5)	3,000	3,000
Prepaid Rent	750	500
Repair Parts on Hand	3,500	3,700
Retained Earnings	5,050	6,300

December 31

19X2 19X1

1-2. Refer to your comparative balance sheet in Exercise 1-1 and answer the following questions.
  (a) If dividends of $3,000 were paid to the stockholders during 19X2, what was the amount of net income?
  (b) What is the current ratio and the equity ratio for both 19X1 and 19X2?
  (c) What is the return on assets for 19X2?

1-3. From the following accounts, prepare an income statement in the space below for the Nathan Appliance Repair, Inc., for 19X2. Calculate the return on sales.

Depreciation Expense—Equipment	$ 500
Depreciation Expense—Delivery Truck	1,000
Repair Service Fees	75,800
Interest Expense	750
Rent Expense	3,000
Salaries Expense	50,000
Supplies Expense	1,500
Repair Parts Used	12,300
Income Tax Expense	500
Utilities Expense	1,800
Delivery Expense	2,700
Capital Stock, $10 Par Value	5,000

ANSWERS TO CHECK YOUR KNOWLEDGE

True or False

1. F 2. F 3. F 4. T 5. T 6. F 7. T 8. F 9. T 10. T 11. F 12. F

Completion

1. recording, classifying, reporting, interpreting 2. generally accepted accounting principles 3. internal auditor 4. certified public accountant 5. balance sheet, income statement 6. assets, liabilities, owners' equity 7. Assets 8. corporation, partnership, sole proprietorship 9. statement, owners' equity 10. Revenues, expenses 11. 24,000 12. going concern 13. Earnings per share 14. current ratio 15. Return on assets 16. sources, uses, changes in components 17. Working capital

ANSWERS TO EXERCISES

1-1.

Nathan Appliance Repair, Inc.
Comparative Balance Sheet

		December 31 19X2		December 31 19X1
Assets				
Current Assets				
Cash		$ 6,200		$ 5,700
Accounts Receivable		4,800		3,800
Prepaid Rent		750		500
Repair Parts on Hand		3,500		3,700
Total Current Assets		$15,250		$13,700
Long-term Assets				
Delivery Truck	$ 8,500		$8,500	
Less: Accumulated Depreciation	2,500	6,000	1,500	7,000
Equipment	$ 6,000		$6,000	
Less: Accumulated Depreciation	2,500	3,500	2,000	4,000
Total Assets		$24,750		$24,700
Liabilities and Stockholders' Equity				
Current Liabilities				
Accounts Payable		$10,200		$ 8,400
Notes Payable (due in 90 days)		1,500		2,000
Total Current Liabilities		$11,700		$10,400
Long-term Liabilities				
Notes Payable (due March 15, 19X5)		3,000		3,000
Total Liabilities		$14,700		$13,400
Stockholders' Equity				
Capital Stock, $10 Par Value	$ 5,000		$5,000	
Retained Earnings	5,050		6,300	
Total Stockholders' Equity		10,050		11,300
Total Liabilities and Stockholders' Equity		$24,750		$24,700

1-2.

(a)

Retained Earnings, December 31, 19X1	$6,300	$6,300
Less: Dividends	3,000	3,000
	$3,300	$3,300
Net Income for 19X2	?	1,750
Retained Earnings, December 31, 19X2	$5,050	$5,050

(b) $$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$13{,}700}{\$10{,}400} = 1.32$$

$$\frac{\$15{,}250}{\$11{,}700} = 1.30$$

$$\text{Equity Ratio} = \frac{\text{Stockholders' Equity}}{\text{Total Assets}} = \frac{\$11{,}300}{\$24{,}700} = 0.458$$

$$\frac{\$10{,}050}{\$24{,}750} = 0.406$$

(c) $$\text{Return on Assets} = \frac{\text{Net Income}}{\text{Average Total Assets}} = \frac{\$1{,}750}{(\$24{,}750 + \$24{,}700)/2} = 0.0708$$

1-3. **Nathan Appliance Repair, Inc.**
Income Statement
For the Year Ended December 31, 19X2

Revenues		
Repair Service Fees		$75,800
Operating Expenses		
Salaries Expense	$50,000	
Repair Parts Used	12,300	
Depreciation Expense—Equipment	500	
Depreciation Expense—Delivery Truck	1,000	
Interest Expense	750	
Rent Expense	3,000	
Supplies Expense	1,500	
Utilities Expense	1,800	
Delivery Expense	2,700	
Income Tax Expense	500	
Total Operating Expenses		74,050
Net Income		$ 1,750
Earnings per Share		$3.50

$$\text{Earnings per Share} = \frac{\$1{,}750}{\$5{,}000/\$10} = \$3.50$$

$$\text{Return on Sales} = \frac{\$1{,}750}{\$75{,}800} = 0.0231$$

2 ANALYZING AND RECORDING CHANGES IN FINANCIAL STATEMENTS

CHAPTER REVIEW

1. The simple form of the balance sheet equation, Assets = Liabilities + Owners' Equity, must be adjusted for easy analysis of the many transactions that may affect owners' equity daily.
2. Owners' equity may be increased by revenues and capital contributions and decreased by expenses and capital withdrawals.
3. In a corporation's balance sheet, **stockholders' equity** is divided into capital stock and retained earnings.
4. **Retained earnings** are increased by revenues and decreased by expenses and dividends (the distributions to the stockholders).
5. Transactions result from exchanges of money, goods, and services with outsiders; adjustments originate within the business.
6. Each transaction can be analyzed in terms of the changes in the dollar amounts of assets, liabilities, and components of stockholders' equity resulting from the transaction.
7. Only revenues and expenses determine the amount of net income.
8. Revenue is recognized at the time it is earned, although cash may not be exchanged at that time.
9. Adjustments must be made before statements are prepared at the end of a specified period to recognize expenses that result from the expiration of assets or the passage of time.
10. The collection of accounts receivable does not result in the recognition of revenue.
11. **Depreciation** is recorded to reflect the expense, or expiration, of a portion of the cost of a long-term asset. The historical cost of the asset remains in the asset account and the expired portion is recorded in the Accumulated Depreciation account.
12. Expenses are recorded by adjustments if items such as utilities or other services have been used and bills have not been received. The amounts must be estimated.
13. The **account,** the basic component of the accounting system, is an individual record of the increases and decreases in a specific asset, liability, or element of stockholders' equity (capital stock, revenues, expenses, and dividends).
14. An account may appear in the following forms: (a) the two-column form with places for the account title and number, dates, descriptive notations, increases and decreases, and cross references to other accounting records; (b) the skeleton T account used for

illustrations and calculations; or (c) the "running balance," or "three-column" ledger form, which has a column for the account balance.
15. The balance of a two-column account or a T account may be determined by deducting the decreases from the total of the increases plus the beginning balance.
16. **Debits** are the entries on the left side of any account, and **credits** are the entries on the right side of any account.
17. Debits are used to record increases in assets and expenses; asset and expense accounts normally have debit balances.
18. Credits are used to record increases in liabilities, components of stockholders' equity, and revenues; these accounts normally have credit balances.
19. Debits are used to record decreases in liabilities, components of stockholders' equity, and revenues; credits are used to record decreases in assets and expenses.
20. Each transaction is recorded with equal dollar amounts of total debits and total credits. One or more debits and credits may be used.
21. A **contra account** such as Accumulated Depreciation may be used to record reductions or offsets against a related account.
22. Net income for the accounting period is determined by deducting all expenses from all revenues. Net income must be determined before retained earnings can be determined.
23. Retained earnings can be computed by adding net income for the period to the beginning balance of retained earnings and deducting dividends declared during the period.
24. If the business form is a proprietorship, the owner's equity will have only a capital account, which includes both earnings and contributions.
25. Withdrawals by the owner of a proprietorship are recorded in an owner's drawing account, which is a contra account to the owner's capital account.
26. Proprietorships have no salaries to the owners or income tax expense on the financial statements.
27. The **general ledger** contains all the accounts for the business entity. It is usually contained in a binder that allows for the addition or removal of accounts as needed.
28. A **trial balance**, a listing of all the general ledger accounts and their respective balances, is used to determine that debits and credits are equal and to show a concise record of all account balances.
29. A trial balance that is in balance may still contain the following errors: (a) an unrecorded transaction, (b) a transaction entered more than once, (c) one or more amounts entered in the wrong account, and (d) an error that exactly offsets another error.
30. If a trial balance does not balance, determine the amount of the imbalance. If a debit or credit is interchanged, the amount of the imbalance will be twice the amount of the entry. The discrepancy resulting from a transposition error is always divisible by 9. If an item is omitted, the amount of the discrepancy is the amount omitted. Combinations of errors usually must be found by tracing the entries back to the records until the trial balance can be balanced.

CHECK YOUR KNOWLEDGE

True or False

If the following statements are generally true, circle the T; if they are generally false, circle the F.

T F 1. Most of the transactions affecting the owners' equity account would be revenue and expense transactions if the abbreviated basic accounting equation were utilized in the accounting system.

T F 2. If the expanded accounting equation is used, it is necessary to record all transactions before the equation will balance.

T F 3. The three-column account form provides places for increases and decreases in the account as well as the balance.

T F 4. "The books are in balance" implies that all the accounting records have been properly maintained.

T F 5. The stockholders' equity section of the balance sheet of a corporation will contain both Capital Stock and Retained Earnings accounts.

T F 6. The general ledger may be a loose-leaf binder of all the accounts necessary to record the transactions of a business entity.

T F 7. If the trial balance indicates equal debits and credits for the accounts in the general ledger, you may be sure that you have properly recorded the transactions for the period.

T F 8. The balance of the contra account, Accumulated Depreciation, reflects the total amount of depreciation taken to date on the related assets.

T F 9. The drawing account, which accumulates the amounts the owner has withdrawn for personal use, is a contra account to the owner's capital account.

T F 10. Failure to record part of a particular transaction can always be detected by taking a trial balance.

T F 11. It is possible to determine if all debits and credits have been entered in the proper accounts by taking a trial balance.

T F 12. The trial balance will be out of balance by an amount divisible by 9 if only a transposition error was made when the transactions were entered into the accounts.

T F 13. The trial balance should include the data needed to prepare the income statement on that date.

Completion

Complete the following statements by writing the appropriate word or phrase in the blanks.

1. The Retained Earnings account is increased by ____________ ____________ and reduced by ________________.
2. ______________ result from exchanges of money, goods, and services with outsiders, while ______________ originate within the business.
3. An __________ can be defined as a record of the increases and decreases in a specific business category.
4. The balance of any account is the beginning balance plus __________ less __________.
5. The ________ entry is always recorded on the left side of the account.
6. Asset accounts are increased by __________; liability accounts are increased by ________; owners' equity accounts are increased by __________; revenue accounts are increased by ____________; expense accounts are increased by __________.
7. A __________ account represents an offset or a reduction of the balance in a related account.
8. The ____________ ____________ is a list of the account titles in the ledger with their respective debit and credit balances.
9. A __________ of a number is simply a reversal of the order of the digits. The resulting discrepancy is always divisible by __________.
10. If an amount is entered on the wrong side of an account—for example, as a debit instead of a credit—the trial balance will be out of balance by ____________ the amount.

EXERCISES

2-1. Modern Service, Inc., was incorporated by Samuel Nilsen to furnish carpet-cleaning services. Following is a series of symbols for elements of the balance sheet equation and a series of account titles, each with a code number.

A = Assets L = Liabilities CS = Capital Stock RE = Retained Earnings

1 Cash
2 Accounts Receivable
3 Prepaid Rent
4 Supplies on Hand
5 Equipment
6 Accumulated Depreciation
7 Accounts Payable
8 Income Tax Payable

9 Notes Payable
10 Capital Stock
11 Retained Earnings
12 Cleaning Fees
13 Advertising Expense
14 Wages and Salaries Expense
15 Rent Expense
16 Depreciation Expense
17 Utilities Expense
18 Supplies Expense
19 Income Tax Expense
20 Dividends

Place the symbols and account code numbers in the columns of the answer grid to indicate for each transaction or adjustment:

(a) In Column (A): The balance sheet equation elements affected.
(b) In Column (B): Whether each element in (A) is increased (+) or decreased (−).
(c) In Column (C): The code number of any accounts to be debited.
(d) In Column (D): The code number of any accounts to be credited.

The first transaction is completed as an example.

Transaction	Col. A	Col. B	Col. C	Col. D
1. Issued 1,000 shares of capital stock for cash.	A, CS	+ +	1	10
2. Purchased carpet-cleaning equipment with a partial payment and the remainder due on notes payable.				
3. Purchased on account supplies needed for the first month of operations.				
4. Paid three-months' rent on a panel truck to carry equipment and workers to client's home.				
5. Received cash from the first customer for cleaning rugs in six rooms. (Not previously recorded.)				
6. Paid charges for March telephone service.				
7. Submitted a bill to the Travel Inn for cleaning carpets in 100 guest rooms and banquet rooms. Received 20% down payment.				
8. Paid wages to the two helpers for March.				
9. Submitted bills to clients for carpets cleaned during the second week of March.				
10. Paid salary to Nilsen, the manager.				
11. Received a check from the Travel Inn for its bill of a week ago.				
12. Purchased additional equipment on account.				
13. Sent a check in payment of the first note for the first purchase of equipment (Item 2 above).				
14. Paid for an advertisement in the local newspaper.				
15. Received cash from several clients not yet billed for carpets cleaned.				
16. Submitted bills to customers for large cleaning jobs.				
17. Received a bill from the service station for gasoline and other items purchased during March.				
18. Recorded depreciation for the month on the equipment.				
19. Recorded the supplies used during the month.				
20. Recorded the expiration of one-month's rent on the truck.				
21. Estimated the income tax for the month.				

2-2. The following transactions occurred in January, the first month of operations of the Middaugh Service Agency. Instructions: (a) Enter transactions (1) through (20) in the accounts provided, a three-column account for cash and T accounts for the remainder, keying the account entries to the numbers of the transactions. (b) After all transactions have been recorded, balance the accounts where more than one entry has been made.

(c) Prepare a trial balance for January 31, 19XX. (d) From the trial balance prepare an income statement for January.

(1) Gerald Middaugh sold 1,000 shares of authorized capital stock for $15,000 and deposited this amount in a bank account to start Middaugh Service Agency.
(2) A suitable building was rented for one year. The January and February rent of $250 per month was paid in advance.
(3) Supplies were purchased from the Main Supply Company for $350 on a 30-day account.
(4) A suitable truck was purchased from Park Motor Company. The down payment was $2,000, and installment notes were signed for $4,500.
(5) Middaugh paid $200 for advertisements that were to be published the next three days in *The Daily News*.
(6) The first client paid $500 for services furnished.
(7) R. Taylor was paid $350 for the first two weeks he served as Middaugh's helper.
(8) Mr. Middaugh was paid $500 for his personal services.
(9) Other clients were billed $800 for services provided during the first week of the month.
(10) Equipment was purchased for $750 on a 30-day account.
(11) Clients were billed $2,200 for services on account, and $800 was received from cash customers.
(12) The company received $600 in payment of accounts receivable.
(13) Additional supplies were purchased for $750 on a 30-day account.
(14) R. Taylor was paid $350 for the second two-week period in January.
(15) Income tax payable at the end of the month is estimated at $400.
(16) A check for $350 was mailed to Main Supply Company in payment of a 30-day account.
(17) A count of the supplies on hand showed that supplies costing $385 had been used during January.
(18) The depreciation expense on the truck for the month was $150.
(19) The depreciation expense on the equipment was $30.
(20) The company estimated that it had used $85 worth of utilities during January for which it had not been billed.

Cash **Account No.______**

Date		Description	Post. Ref.	Debit*	Credit	Balance