ANSWERS TO QUESTIONS

1. The primary objective of financial reporting for external users is to provide useful economic information about a business to help external parties, primarily investors and creditors, make sound financial decisions. These users are expected to have a reasonable understanding of accounting concepts and procedures. Usually, they are interested in information to assist them in projecting future cash inflows and outflows of a business.

2. (a) An asset is a probable future economic benefit owned by the entity as a result of past transactions.

(b) A current asset is an asset that will be used or turned into cash within one year; inventory is always considered a current asset regardless of how long it takes to produce and sell the inventory.

(c) A liability is a probable debt or obligation of the entity as a result of a past transaction, which will be paid with assets or services.

(d) A current liability is a liability that will be paid in cash (or other current assets) or satisfied by providing service within the coming year.

(e) Contributed capital is the financing provided to the business by owners; usually owners provide cash and sometimes other assets such as equipment and buildings.

(f) Retained earnings are the cumulative earnings of a company that are not distributed to the owners and are reinvested in the business.
3. (a) The separate-entity assumption requires that business transactions are separate from the transactions of the owners. For example, the purchase of a truck by the owner for personal use is not recorded as an asset of the business.

(b) The unit-of-measure assumption requires information to be reported in the national monetary unit. That means that each business will account for and report its financial results primarily in terms of the national monetary unit, such as Yen in Japan and Australian dollars in Australia.

(c) Under the continuity or going-concern assumption, businesses are assumed to operate into the foreseeable future. That is, they are not expected to liquidate.

(d) The historical cost principle requires assets to be recorded at the cash-equivalent cost on the date of the transaction. Cash-equivalent cost is the cash paid plus the dollar value of all noncash considerations.

4. Accounting assumptions are necessary because they reflect the scope of accounting and the expectations that set certain limits on the way accounting information is reported.

5. An account is a standardized format used by organizations to accumulate the dollar effects of transactions on each financial statement item. Accounts are necessary to keep track of all increases and decreases in the fundamental accounting model.

6. The fundamental accounting model is provided by the equation:

   \[ \text{Assets} = \text{Liabilities} + \text{Stockholders' Equity} \]

7. A business transaction is (a) an exchange of resources (assets) and obligations (debts) between a business and one or more outside parties, and (b) certain events that directly affect the entity such as the use over time of rent that was paid prior to occupying space and the wearing out of equipment used to operate the business. An example of the first situation is (a) the sale of goods or services. An example of the second situation is (b) the use of insurance paid prior to coverage.

8. Debit is the left side of a T-account and credit is the right side of a T-account. A debit is an increase in assets and a decrease in liabilities and stockholders' equity. A credit is the opposite -- a decrease in assets and an increase in liabilities and stockholders' equity.
9. Transaction analysis is the process of studying a transaction to determine its economic effect on the entity in terms of the accounting equation:
   \[ \text{Assets} = \text{Liabilities} + \text{Stockholders' Equity} \]

   The two principles underlying the process are:
   * every transaction affects at least two accounts.
   * the accounting equation must remain in balance after each transaction.

   The two steps in transaction analysis are:
   1. identify and classify accounts and the direction and amount of the effects.
   2. determine that the accounting equation \( A = L + SE \) remains in balance.

10. The equalities in accounting are:
   1. \( \text{Assets} = \text{Liabilities} + \text{Stockholders' Equity} \)
   2. \( \text{Debits} = \text{Credits} \)

11. The journal entry is a method for expressing the effects of a transaction on accounts in a debits-equal-credits format. The title of the account(s) to be debited is (are) listed first and the title of the account(s) to be credited is (are) listed underneath the debited accounts. The debited amounts are placed in a left-hand column and the credited amounts are placed in a right-hand column.

12. The T-account is a tool for summarizing transaction effects for each account, determining balances, and drawing inferences about a company's activities. It is a simplified representation of a ledger account with a debit column on the left and a credit column on the right.

13. The current ratio is computed as current assets divided by current liabilities. It measures the ability of the company to pay its short-term obligations with current assets. A high ratio normally suggests good liquidity, but a ratio that is too high may indicate inefficient use of resources. The rule of thumb was a ratio between 1.0 and 2.0 (twice as many current assets as current liabilities), but sophisticated cash management systems allow many companies to minimize funds invested in current assets and have a current ratio below 1.0.

14. Investing activities on the statement of cash flows include the buying and selling of productive assets and investments. Financing activities include borrowing and repaying debt, issuing and repurchasing stock, and paying dividends.
MULTIPLE CHOICE

1. b  
2. d  
3. b  
4. a  
5. d

6. c  
7. d  
8. d  
9. b  
10. a