CHAPTER 3  Chapter Outline Notes

Business Transactions and the Accounting Equation

Section 1: Property and Financial Claims

A. Property

- **property**—anything of value that a person or business owns and therefore controls
- When you own an item of property, you have a legal right to that item.
- **financial claim**—a legal right to an item

PROPERTY = FINANCIAL CLAIMS

- In accounting, property and financial claims are measured in dollar amounts.
- **credit**—when you buy something and agree to pay for it later
- When you buy property on credit, you do not have the only financial claim to the property.
- **creditor**—the business or person selling you the item on credit

B. Financial Claims in Accounting

- **assets**—property or items of value owned by a business
- **equities**—the accounting term for financial claims to assets
- **owner’s equity**—the owner’s claims to the assets of the business
- **liabilities**—the creditor’s claims to the assets of the business; in other words, the debts of a business
- **accounting equation**—the relationship between assets and the two types of equities (liabilities and owner’s equity)

ASSETS = LIABILITIES + OWNER’S EQUITY

Section 2: Transactions That Affect Owner’s Investment, Cash, and Credit

A. Business Transactions

- **business transaction**—an economic event that causes a change—either an increase or a decrease—in assets, liabilities, or owner’s equity
- **account**—a subdivision under assets, liabilities, or owner’s equity that shows the increases or decreases for that item
- **accounts receivable**—the total amount of money owed to a business—money to be received later because of the sale of goods or services on credit
- **accounts payable**—the amount owed, or payable, to the creditors of a business

B. Effects of Transactions on the Accounting Equation

1. Investments by the Owner

   - **investment**—money or other property paid out in order to produce profit

2. Cash Payment Transactions

3. Credit Transactions

   - **on account**—when a business buys an item on credit
Section 3: Transactions That Affect Revenue, Expense, and Withdrawals by the Owner

A. Revenue and Expense Transactions
- **revenue**—income earned from the sale of goods or services
- Revenue increases owner's equity because it increases the assets of the business.
- **expense**—the cost of products or services used to operate a business
- Expenses decrease owner's equity because they decrease the assets of the business or increase liabilities.

B. Withdrawals by the Owner
- **withdrawal**—removal of cash or another asset from the business for the owner's personal use
- A withdrawal decreases both assets and owner's equity.
- A withdrawal is not the same as an expense.
CHAPTER 3  Concept Assessment

Business Transactions and the Accounting Equation

PART A  Accounting Vocabulary  (15 points)

Directions: Using terms from the following list, complete the sentences below. Write the letter of the term you have chosen in the space provided.

A. account
B. accounting equation
C. accounts payable
D. accounts receivable
E. asset
F. business transaction
G. capital
H. creditor
I. equities
J. expenses
K. liabilities
L. on account
M. owner’s equity
N. property
O. revenue
P. withdrawal

0. The _____ is Assets = Liabilities + Owner’s Equity.
1. A(n) _____ is an economic event that causes a change in assets, liabilities, or owner’s equity.
2. The owner’s claims to the total assets of the business are called _____.
3. A(n) _____ is any property or item of value owned by a business.
4. _____ are the creditor’s claims to the assets of the business.
5. _____ is anything of value that is owned or controlled.
6. The increases or decreases in a specific item caused by business transactions are recorded in a(n) _____.
7. Buying _____ is the same as buying on credit.
8. _____ is income earned from the sale of goods and services.
9. The costs of goods and services used to operate a business are _____.
10. _____ is the total amount of money to be received in the future for goods and services sold on credit.
11. A person or business that sells property on credit, or any person or business to which money is owed, is called a(n) _____.
12. The total financial claims to the assets of a business are known as _____.
13. The amount of money owed to the creditors of a business is _____.
14. _____ refers to the dollar amount of the owner’s equity in the business.
15. When the owner takes cash or other assets from the business for personal use, a _____ occurs.

PART B  Property and Financial Claims  (4 points)

Directions: Read each of the following statements to determine whether the statement is true or false.

Answer
T  F  0. When you buy property on account, you acquire all of its property rights.
T  F  1. One of the purposes of accounting is to provide financial information about property and the rights of a business to that property.
T  F  2. A person who has control over but does not own an item of property has a legal right to that item.
T  F  3. Both businesses and individuals may own and control property.
T  F  4. The creditor’s financial claim minus the owner’s financial claim to an item of property always equals the total cost of the property.
Concept Assessment cont.

PART C Analyzing Business Transactions (10 points)

Directions: Listed below are the account names that are used by In-a-Minute Messenger Service for recording and reporting the financial information from business transactions.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Office Supplies</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Analyze each of the following transactions to determine the accounts affected. Then enter the numbers of the accounts affected by each transaction in the space at the left. Remember that at least two accounts will be affected by each transaction. The first transaction has been completed as an example.

**Accounts Affected**

0. The owner invested cash in the business.  
1. Paid for the monthly rent by check.  
2. The owner transferred a new bicycle to the business for deliveries.  
3. Received cash for delivering messages.  
4. Purchased office equipment on account.  
5. Delivered messages for a client on account.  
6. Sold to a friend a bicycle helmet owned by the business on account.  
7. Issued a check to a creditor in partial payment of amount owed.  
8. Purchased office supplies on account.  
9. Withdrew cash for personal use.  
10. Wrote a check for the monthly telephone bill.

PART D Effects of Business Transactions on the Accounting Equation (10 points)

Directions: The business transactions completed by Carolyn Corley, Attorney at Law, appear below. Each business transaction will cause an increase (+), decrease (−), or no change (0) in the classification of accounts in the accounting equation. Analyze each transaction to determine how it affects the accounting equation (increase, decrease, no change). Then, in the space at the left, use +, −, or 0 to indicate the effect of each transaction on each part of the accounting equation.

**Assets = Liabilities + Owner’s Equity**

0. The owner transferred a typewriter to the business.  
1. Bought office furniture on account.  
2. The owner invested cash in the business.  
3. Paid the monthly utility bill by check.  
4. Purchased office supplies for cash.  
5. Prepared a lease for a client on account.  
6. Withdrew cash from the business for personal use.  
7. Bought a computer for cash.  
8. Received cash for completing legal services.  
9. Wrote a check to a creditor for an amount owed on account.  
10. Wrote a check for the monthly rent.
PART A   True or False

Directions: Read each of the following statements to determine whether the statement is true or false.

Answer

1. The accounting equation should remain in balance after each transaction.  
   T  F

2. A business transaction affects at least two accounts.  
   T  F

3. “Assets + Liabilities = Owner’s Equity” is another way to express the accounting equation.  
   T  F

4. The increases and decreases caused by business transactions are recorded in specific accounts.  
   T  F

5. The free enterprise system is based on the right to own property.  
   T  F

6. The owner’s personal financial transactions are part of the business’s records.  
   T  F

7. The total financial claims to the assets of a business are referred to as equities.  
   T  F

8. The owner’s claims to the assets of a business are liabilities.  
   T  F

9. When a business transaction occurs, the financial position of the business always changes.  
   T  F

10. A creditor has a financial claim to the assets of a business.  
    T  F

11. An account is a record of only the increases in the balance of a specific item such as cash or equipment.  
    T  F

12. The total financial claims do not have to equal the total cost of the property.  
    T  F
Quick Quiz cont.

PART B  Multiple Choice

Directions: Only one of the choices given with each of the following statements is correct. Write the letter of the correct answer in the Answer column.

Answer

1. If the creditor’s financial claim to property totals $1,000 and the owner’s financial claim to property totals $11,000, the property value is
   (A) $10,000.  (C) $12,000.
   (B) $11,000.  (D) $1,000.

2. The account Accounts Receivable is an example of a(n)
   (A) asset.  (C) owner's equity.
   (B) liability.  (D) none of the above.

3. All of the following account names are asset names, except
   (A) Office Furniture.  (C) Cash in Bank.
   (B) Accounts Payable.  (D) Equipment.

4. If a business has assets of $5,600 and liabilities of $900, the owner’s equity is
   (A) $6,500.  (C) $4,700.
   (B) $900.  (D) $5,600.

5. A business transaction that involves a purchase on account is considered to be a(n)
   (A) cash transaction.
   (B) credit transaction.
   (C) investment by the owner.
   (D) expense transaction.

6. If a business purchases a calculator on account, the accounts affected by this transaction are
   (A) Cash in Bank and Accounts Payable.
   (B) Office Equipment and Accounts Receivable.
   (C) Office Equipment and Cash in Bank.
   (D) Office Equipment and Accounts Payable.

7. Each of the following is a business expense, except payment for
   (A) advertising.  (C) utility bills.
   (B) monthly rent.  (D) equipment.

8. The purchase of a desk on account will increase Office Furniture and will also increase
   (A) Cash in Bank.  (C) Accounts Receivable.
   (B) Accounts Payable.  (D) Jon McIvey, Capital.
CHAPTER 3

Chapter Quiz

Business Transactions and the Accounting Equation

Completion

Directions: Fill in the blank with the term that best completes each sentence.

1. ___________ is anything of value that a business owns or controls.

2. Property rights are ___________ claims to property.

3. ___________ represents the financial claim to business assets.

4. An economic event for a business is a ___________.

5. Accounts ___________ represent amounts owed to a business.

6. Accounts ___________ represent amounts owed by a business.

7. When a business uses credit to buy items, it is buying ___________.

8. A business that earns money from selling goods or services earns ___________.

9. The price a business pays for goods or services is an ___________.

10. Money taken from the business by the owner for personal use is a ___________.

CHAPTER 3
Demonstration Problems

Business Transactions and the Accounting Equation

PROBLEM 3–1  Assessing Financial Claims
You bought a coat for $60 cash. In equation form, what is the relationship between the property and your financial claims?

\[ \text{PROPERTY} = \text{FINANCIAL CLAIMS} \]

\[ \$\text{60} = \$\text{60} \]

PROBLEM 3–2  Sharing Financial Claims with a Creditor
You want to buy a bicycle that costs $200, but you have only $45. E and T Sports Store agrees to sell you the bicycle on credit. You pay $45 down and sign an agreement to pay the remaining $155 in installment payments. How can you show this purchase using the equation \( \text{PROPERTY} = \text{FINANCIAL CLAIMS} \)?

\[ \text{PROPERTY} = \text{FINANCIAL CLAIMS} \]

\[ \$\text{200} = \$\text{45} + \$\text{155} \]

PROBLEM 3–3  Applying the Accounting Equation
Same Day Cleaners just bought a new cash register for $2,400. The business made a down payment of $400 and borrowed the remaining $2,000 from a local bank. How does the accounting equation apply in this example?

\[ \text{PROPERTY} = \text{FINANCIAL CLAIMS} \]

\[ \$\text{2,400} = \$\text{400} + \$\text{2,000} \]

PROBLEM 3–4  Classifying Accounts
The account names used by Alexander Company are listed below. Indicate which accounts are assets, liabilities, and owner’s equity.

- Accounts Payable
- Accounts Receivable
- Cash in Bank
- Computer Equipment
- Store Equipment
- M. Crabtree, Capital

Assets: _______________________________________

Liabilities: _____________________________________

Owner’s Equity: __________________________________
Demonstration Problems cont.

PROBLEM 3–5  Determining Effects of Transactions on the Accounting Equation

For each transaction:
(1) Identify the accounts affected.
(2) Classify the accounts affected.
(3) Determine the amount of the increase or decrease for each account.
(4) Show the new account balances in the accounting equation.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liab.</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in Bank</td>
<td>Accts. + Office + Del. = Accts. + Marion Butler, Capital</td>
<td></td>
</tr>
</tbody>
</table>

Owner’s Investment
1. Marion Butler deposited $25,000 in the bank to open a checking account in the name of Butler Florist.

Line 1
2. The owner invested a calculator worth $200.

Line 2

Line 1 + 2

Cash Transaction
3. Butler Florist issued a check for $10,000 for delivery equipment.

Line 4
4. Butler Florist bought a copier on account for $2,400.

Line 5

Credit Transactions
5. Butler Florist issued a check for $400 in partial payment of an amount owed to a creditor.

Line 8

Line 7 + 8

Line 9

Expense Transaction
6. Butler Florist sold the calculator for $200 on account.

Line 10

Line 9 + 10

Revenue Transaction
7. Butler Florist received a check for wedding floral arrangement services, $1,200.

Line 12

Line 11 + 12

Expense Transaction
8. Butler Florist wrote a check for $1,000 to pay the monthly rent.

Line 14

Line 13 + 14

Withdrawal by Owner
9. The business issued a check for $1,000 to Marion Butler for personal use.

Line 16

Line 15 + 16