# STUDENT MASTERY GUIDE

CHARLES A. NEYHART, JR., AND PATRICK S. KEMP

# FOURTH HINANCIAL ACCOUNTING

ROBERT K. ESKEW / DANIEL L. JENSEN



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## Student Mastery Guide FINANCIAL ACCOUNTING, Eskew and Jensen

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1234567890 SEM SEM 90987654321

ISBN 0-07-021057-8

The editors were Johanna Schmid and Judy Motto; the production supervisor was Leroy Young. Semline, Inc., was printer and binder.

### **Preface**

The Student Mastery Guide is designed to be used with the text Financial Accounting by Robert K. Eskew and Daniel L. Jensen. The purpose of the Guide is to actively assist you in mastering the various accounting principles and procedures presented in the textbook. Working through the Student Mastery Guide should reinforce what you have learned in the textbook and help you prepare for examinations:

Each chapter of the Guide contains the following sections:

- The Learning Objectives identify the significant material within the corresponding text chapter and focus on what you should learn in that chapter. (For purposes of efficiency and practicality, some learning objectives in the text have been combined and/or restated in the Guide.)
- The Diagnostic Pretest consists of both multiple choice and true-false questions and is intended to assist you in identifying those learning objectives that you did not adequately master in your initial coverage of the text chapter.
- The Chapter Outline provides an overview of the chapter in a manner that parallels the major headings of the text.
- The Chapter Review provides a summary of the significant contents of the corresponding text chapter.
- The Key Term Review gives you practice in the use of accounting terminology.
- The Practice Questions, Exercises, and Problems section consists of a variety of questions and numerical problems designed to allow you to further improve your mastery of the principles and procedures covered in the text chapter.
- Common Errors is unique to study guides in accounting. This section identifies errors that students frequently make and explains the correct accounting treatment.
- Two Post-Tests, each containing a selection of true-false, multiple choice, matching, and short problems, are included to enable you to measure the extent of your mastery of the learning objectives. These tests are fairly rigorous; hence, students who do well should have confidence in their mastery of the chapter material.

We would like to thank our editors, Johanna Schmid and Judy Motto, for the guidance and encouragement they provided us during the preparation of the Student Mastery Guide.

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## INTRODUCTION TO ACCOUNTING AND ACCOUNTANTS

#### I. LEARNING OBJECTIVES

After reading and studying Chapter 1, you should be able to do the following:

- 1. Explain the purpose of accounting and identify different forms of business entities and business activities.
- 2. Describe the structure of the accounting profession.
- 3. State the purpose of generally accepted accounting principles and auditors' opinions.
- 4. Recognize the primary financial statements.
- 5. Explain the concepts of assets, liabilities, and equity and write the fundamental accounting model.
- 6. Explain the concepts of revenue and expense and describe the relationship of the statement of changes in retained earnings to the income statement and balance sheet.

#### II. A. DIAGNOSTIC PRETEST

#### Multiple Choice

Circle the letter of the best answer in each of the following items.

- 1. Which of the following is not a component of the definition of accounting?
  - a. the process of identifying, measuring, and communicating
  - b. economic information
  - c. about the value of an accounting entity
  - d. to permit informed judgments and decisions of the information
  - e. All of the above are parts of the definition of accounting.
- 2. An additional cash investment by a business owner would increase the total amount of assets to be reported in
  - a. the owner's personal balance sheet.
  - b. the business's balance sheet.
  - c. both the owner's personal balance sheet and the business's balance sheet.
  - d. neither the owner's personal balance sheet nor the business's balance sheet.
  - e. It would depend on what the owner intended to purchase with the cash.

- 3. Which of the following accounting positions would not be likely to be found in a business entity?
  - a. treasurer
  - b. internal auditor
  - c. controller
  - d. audit partner of the firm
  - e. managerial accountant
- 4. The primary objective of an audit of financial statements by an independent auditor is the expression of an informed, expert opinion on the
  - a. technical competence of management in accounting matters.
  - b. reasonableness of financial statement presentations.
  - c. appropriateness of the financial statements for their intended use.
  - d. conformity of the financial statements with the underlying accounting system that produced them.
  - e. conformity of the financial statements with the guidelines established by the Internal Revenue Service.
- 5. The main source of official pronouncements on generally accepted accounting principles is the
  - a. Financial Executives Institute.
  - b. American Institute of Certified Public Accountants.
  - c. American Accounting Association.
  - d. Securities and Exchange Commission.
  - e. Financial Accounting Standards Board.
- 6. Generally accepted accounting principles consist of
  - a. uncodified practices and procedures of the accounting profession.
  - b. rules and guidelines established by the Internal Revenue Service and by state and local taxing agencies.
  - c. official pronouncements (standards) of the private sector and governmental agencies.
  - d. both a and c.
  - e. all of the above.
- 7. The purpose of the income statement is to provide information about
  - a. an entity's economic resources and claims against these resources at a point in time.
  - b. the profitability of an entity from its business operations for a period of time.
  - c. the change in the cash position for a period of time.
  - d. the accumulated profits of an entity in excess of losses and dividends at a point in time.
  - e. the change in accumulated profits of an entity in excess of losses and dividends for a period of time.
- 8. The purpose of the balance sheet is to provide information about
  - a. an entity's economic resources and claims against these resources at a point in time.
  - b. the profitability of an entity from its business operations for a period of time.
  - c. the change in the cash position for a period of time.
  - d. the accumulated profits of an entity in excess of losses and dividends at a point in time.
  - e. the change in accumulated profits of an entity in excess of losses and dividends for a period of time.
- 9. Assets are customarily reported in the balance sheet on the basis of
  - a. cost, since cost is usually factual and capable of being verified.
  - b. current market value.
  - c. what it would cost to replace the asset.
  - d. what the asset would sell for if the entity were to go out of business.
  - e. what the asset is expected to sell for in the course of normal operations.
- 10. Which of the following equations cannot be derived from the fundamental accounting model?
  - a. Assets Liabilities = Equity
  - b. Liabilities = Assets Equity
  - c. Equity = Liabilities Assets
  - d. Assets Equity = Liabilities
  - e. All of the above are proper derivations from the fundamental accounting model.

- 11. Copeland Used Cars, which uses accrual accounting, sold a panel truck to Whitewater Rafting on November 9 for \$7,500. Copeland purchased the truck on September 22 for \$5,000 and then spent an additional \$1,000 during October to rebuild the engine. The truck was in salable condition and on the display lot on October 27. Whitewater Rafting made a \$2,500 cash down payment on November 9 and promised to pay the balance in two equal monthly installments (December 9 and January 9). In which month(s) should Copeland report the \$7,500 of revenue from this event?
  - a. September
  - b. October
  - c. November
  - d. November, December, and January
  - e. January
- 12. Using the information in Question 11, in which month(s) should Copeland report the related \$6,000 of expense?
  - a. September
  - b. October
  - c. September and October

and related effort.

- d. November
- e. January

#### True-False

In the space provided, mark each of the following statements "T" if it is true or "F" if it is false. 1. Accounting is concerned with communicating economic information only about business entities. Both partnerships and sole proprietorships are characterized by unlimited liability, whereas stockholders of a corporation have a limited legal liability. Managerial accounting reports are intended for use by managers and other decision makers inside a business 3. entity. The General Accounting Office, which audits the operations of the federal government and reports to Congress, is an example of how accountants are employed in public practice within the accounting profession. The chief accounting officer in most business entities is called the controller. Managerial accountants are required by statute to be licensed as certified public accountants. The responsibility for formulating and establishing generally accepted accounting principles has rested primarily with the federal government. To be considered "generally accepted," an accounting principle must be codified in an official pronouncement of the private sector or of governmental agencies. The principal objective of the conceptual framework of accounting is to provide a complete and consistent theoretical structure or framework to be used in the formulation of explicit accounting principles or standards. The balance sheet reports the current market value of an entity. 10. The statement of changes in retained earnings reports all changes in the equity section of the balance sheet during a specified period of time. The income statement summarizes and reports the revenue and expenses for a period of time. 12. 13. Assets represent the right to future services, whether or not they are embodied in physical objects. 14. Equity on the balance sheet represents sources of assets from direct investment by owners and from the undistributed profits of the entity. \_\_15. On the balance sheet of a business entity, each individual share of stock held by stockholders represents an equal share of both capital stock and retained earnings. 16. Total revenue recognized during a period is the net income for that period. 17. Revenues are a measure of the amount of assets received in exchange for goods sold or services rendered to \_\_\_18. Accrual accounting is considered superior to the cash-basis method of accounting in measuring accomplishment

#### II. B. ANSWERS TO DIAGNOSTIC PRETEST

#### Multiple Choice

- 1. c. Since the purpose of accounting is to satisfy diverse information needs of users and decision makers, the nature and scope of the "economic information" in the definition is unspecified. (LO #1)\*
- 2. b. In gathering and reporting information about a business entity, the affairs and resources of the entity must be distinguished and separated from the affairs and resources of the owner. (LO #1)
- 3. d. Alternatives a, b, and c either report to or are part of the entity's management. Thus, they are called managerial accountants. Alternative d is the rank designation of an accountant in public practice. (LO #2)
- 4. b. An important function of an independent audit is to express a judgment that the financial statements constitute a fair and reasonable application of generally accepted accounting principles. A positive judgment in this regard serves to enhance the credibility and reliability of the financial statements for decision-making purposes by users. (LO #2)
- 5. e. (LO#3)
- 6. d. Rules established by the Internal Revenue Service and other taxing agencies are legal guides to the preparation of the income tax return and other tax reports rather than guides to the preparation of financial statements that purport to be in conformity with generally accepted accounting principles for use by those decision makers outside the entity. (LO #3)
- 7. b. ALTERNATIVE PURPOSE
  - a. Balance sheet
  - c. Statement of cash flows
  - d. Retained earnings balance
  - e. Statement of changes in retained earnings

(LO #4)

- 8. a. (LO #4)
- 9. a. Alternatives b to e represent various "values" of an asset. (LO #5)
- 10. c. Alternatives a, b, and d are algebraically correct transformations of the fundamental accounting model. (LO #5)
- 11. c. Accrual accounting identifies revenues and expenses with time periods rather than with cash receipts and payments. Although Copeland will receive cash in November, December, and January, the major accomplishment (that is, revenue from the sale of goods to customers) took place in November. (LO #6)
- 12. d. Expenses measure the cost of assets physically transferred to customers or the cost of assets consumed in the operations of the entity. Since the asset (panel truck) was transferred through sale to Whitewater Rafting in November, the expense associated with the revenue from that transfer should be reported in that month. (LO #6)

#### True~False

- 1. F—Accounting, as a general discipline, identifies, measures, and communicates economic information about both business and nonbusiness entities. (LO #1)
- 2. T—Partnerships and sole proprietorships are not legally separate entities from their owners (although they are considered to be separate accounting entities). Corporations are legal entities separate from the legal identities of their owners. Thus, the legal responsibility of owners for the debts of the entity are different for the corporate form of entity than for the partnership and sole proprietorship forms of entity. (LO #1)
- 3. T—(LO #1)
- 4. F—The General Accounting Office is a governmental agency and thus is an example of how accountants are employed in a nonbusiness group within the accounting profession. (LO #2)
- 5. T-(LO #2)
- 6. F—Public accountants who perform auditing services are required by statute to be licensed as certified public accountants. (LO #2)
- 7. F—Although the Securities and Exchange Commission was granted broad legal powers by Congress to prescribe accepted rules of financial accounting and reporting, the commission has, for the most part, permitted the private sector, currently represented by the Financial Accounting Standards Board, to assume responsibility for this activity. (LO #3)

<sup>\*</sup>LO #\_ refers back to the Learning Objectives and appropriate numbers mentioned at the beginning of each chapter.

- 8. F—Generally accepted accounting principles also include the uncodified practices and procedures of the accounting profession. (LO #3)
- 9. T-(LO #3)
- 10. F-The balance sheet provides information about an entity's economic resources (and their cost) and the claims against those resources by the creditors and owners of the entity. (LO #4)
- 11. F—The equity of a corporation consists of capital stock and retained earnings. The statement of changes in retained earnings does not include an analysis of changes in capital stock. (LO #4)
- 12. T—The difference between revenues and expenses for a period of time (net income or net loss) is a measure of the profitability of the entity for that period. (LO #4)
- 13. T-Some assets, such as accounts receivable and patents, are intangible resources whose value (the right to future services) resides in a legal claim against customers (receivables) or users of an invention (patent). (LO #5)
- 14. T—The equity of a corporation consists of assets from direct investment by owners (capital stock) and from the undistributed profits of the entity (retained earnings). (LO #5)
- 15. T-(LO #5)
- 16. F-Total revenue minus total expenses is the net income for the period. (LO #6)
- 17. T--(LO#6)
- 18. T-Accrual accounting identifies revenues and expenses with the time periods in which the major accomplishment and related effort occur rather than with the time period in which the related cash is received or paid out. (LO #6)

#### Evaluation

The pretest contains five questions for each learning objective. If you have missed more than two questions for any one learning objective, you should reread the chapter and study guide material relating to that learning objective before going beyond Part IV.

#### III. CHAPTER OUTLINE

- A. Accounting defined
- B. Business entities and accounting information
  - 1. Accounting entities
    - a. Business
    - b. Nonbusiness
  - 2. Forms of business entities
    - a. Sole proprietorship
    - b. Partnership
    - c. Corporation
  - 3. Types of business activity
    - a. Merchandising
    - b. Manufacturing
    - c. Service
  - 4. Financial and managerial accounting compared
- C. Accounting profession
  - 1. Groups
    - a. Nonbusiness entities
    - b. Business entities
    - c. Public practice
  - 2. Functions within groups
- D. Generally accepted accounting principles
  - 1. Auditor's opinion
    - a. Nature and scope
    - b. Certified public accountant (CPA)
  - 2. Official pronouncements
    - a. Financial Accounting Standards Board

- b. Securities and Exchange Commission
- 3. Conceptual framework of accounting
  - a. Concepts
  - b. Principles

#### E. Financial statements

- 1. Balance sheet
  - a. Assets and cost(1) Cost and market value
  - b. Liabilities
  - c. Equity
  - d. Fundamental accounting model
- 2. Income statement
  - a. Revenues
  - b. Expenses
  - c. Net income (or loss)
  - d. Accrual basis vs. cash basis
- 3. Statement of changes in retained earnings
- 4. Statement of cash flows

#### IV. CHAPTER REVIEW

Accounting identifies, measures, and communicates economic information about accounting entities to permit informed judgments and decisions by users of the information. These entities, which are organizations of people and resources, can be either business entities established to provide goods and services at a profit (for example, Chrysler, the neighborhood gas station) or nonbusiness entities established to provide goods and services without regard to profitability (for example, governmental units, charities). Both business and nonbusiness entities require accounting systems to maintain a detailed record of economic information in order to issue accounting reports intended to meet the needs of decision makers both inside and outside the entity. The emphasis throughout this text will be on accounting and reporting for business entities.

Business entities engage in three different types of activity: merchandising, manufacturing, and service. Each business entity has an accounting identity of its own, distinct from the identities of the owner(s) of the entity and distinct from other entities. Business entities can take one of three forms. A sole proprietorship is an entity owned by one person. A partnership is an entity owned jointly by two or more persons. The third form of business entity is the corporation, which is formed under state law by one or more owners called stockholders. When a corporation is formed, stockholders transfer resources to the corporation in exchange for shares of stock that represent units of ownership in the corporation. In identifying, measuring, and communicating economic information about business entities regardless of form, it is necessary that the affairs and resources of the entity be distinguished from the personal affairs and resources of the owners as well as from those of other entities. The illustrations throughout the text will emphasize the corporate form of organization.

The accounting system of a business entity reports information of varying types for decision makers inside and outside the entity. Financial accounting is concerned with the preparation of general-purpose financial statements for stockholders, creditors, and other interested parties outside the entity. Managerial accounting, on the contrary, is concerned with the preparation of specifically "tailored" accounting data and reports for use by managers and other decision makers inside the entity. (LO #1)

The accounting profession can be divided into three broad areas: accounting for nonbusiness entities, accounting for business entities, and the public accounting profession. The two major groups of nonbusiness entities that employ accountants are educational institutions (colleges and universities) and local, state, and federal governmental units. Accountants in business entities, frequently called managerial accountants, gather and report accounting information needed for decision making inside the organization (for example, taxation, budgeting, routine operating data) and prepare financial statements required by stockholders, creditors, and other users outside the entity. Public accounting services are rendered by accountants on a fee basis to clients (including business and nonbusiness entities). Public accountants perform auditing services, which involve a detailed examination of an accounting system for the purpose of expressing a written opinion as to the fairness of the financial statements generated by that system. (LO #2)

The preparation and subsequent independent audit of financial statements are guided by a set of rules referred to as generally accepted accounting principles (GAAP). These principles consist of: (1) the official pronouncements (standards) of the private sector and governmental agencies and (2) the uncodified practices and procedures of the accounting

profession. The Financial Accounting Standards Board (FASB) is the main private-sector source of official pronouncements on GAAP. The FASB is designed to be responsive to the views of both preparers and users of financial statements and to the Securities and Exchange Commission, an agency of the federal government established by Congress to ensure public disclosure of important financial information. The FASB is also actively involved in refining the conceptual framework of accounting by developing general accounting concepts that are derived from the fundamental accounting objective of providing useful information and from which GAAP are derived. This theoretical structure of objectives and broad-based concepts serves as a uniform basis in the formulation of more specific accounting principles for use in the preparation and evaluation of financial statements. (LO #3)

The principal financial statements issued by a business entity are the: (1) balance sheet, (2) income statement, (3) statement of changes in retained earnings, and (4) statement of cash flows. The balance sheet provides information about an entity's economic resources and the claims against those resources by the creditors and owners of the business as of a particular point in time. The income statement is a report on the profitability of the entity from business operations (sale of goods or services) during a specific period of time. The statement of changes in retained earnings summarizes the factors that cause the retained earnings balance to change during a given period of time. This statement is the essential link between the income statement and the balance sheet. The statement of cash flows explains why the single asset, cash, changed during a period of time. (A detailed discussion of this latter statement is deferred until Chapter 13.) (LO#4)

The balance sheet consists of assets, liabilities, and equity. Assets are economic resources that represent probable future economic benefits obtained or controlled by an entity. Assets are either tangible (physical substance) or intangible (legal claims) and are reported at their cost in the balance sheet. Liabilities are probable future sacrifices of economic benefits. Equity is the residual interest in the assets of an entity after deducting its liabilities from its assets. Equity arises from two sources: (1) the owners' contribution of assets, called capital stock, and (2) the entity's accumulated profits in excess of losses and payments to owners, called retained earnings. The balance sheet is, in effect, two lists. Assets are presented in one list and liabilities and equity are presented in the other. This reflects the fundamental accounting model: the total dollar amount of assets must equal the total dollar amount of liabilities and equity, or

Assets = Liabilities + Equity

This permanent relationship among balance sheet components is true because the two sides of the balance sheet are merely different ways of characterizing the resources of the entity. The asset side describes resources in terms of their potential economic benefit to the entity. The liability/equity side describes those resources in terms of the persons or organizations that provided the assets and that lay claim to them. (LO #5)

The income statement contains the revenues and expenses of an entity for a period of time. Revenues are the inflows of assets to an entity as a result of transferring (selling) goods or services to customers, and expenses are the outflows or other uses of assets during a period that result from the sale of goods or services by the entity. Generally, revenues and expenses are included in the income statement in the period in which the goods or services are transferred to customers (accrual accounting) rather than in the period in which cash is collected from their sale or paid for (cash-basis accounting). The difference between revenues and expenses for a specific time period is used to measure the profitability of business operations. Net income is derived as the excess of total revenue over total expenses; if total expenses exceed total revenue, the difference is called a net loss.

The statement of changes in retained earnings serves to reconcile the beginning balance of retained earnings (the retained earnings balance as of the end of the previous period) with the ending balance of retained earnings (the retained earnings balance as of the end of the current period and the amount to be reported on the balance sheet as of the end of the current period). Two factors serve to change retained earnings: net income (or net loss) and amounts paid to owners out of profits, called dividends when paid by a corporation. Dividends and net losses reduce retained earnings, whereas net income increases retrained earnings. Thus, the statement describes the change in retained earnings that occurs between two successive balance sheets where the change derives from two sources-net income (or net loss) and dividends-and is the link in the relationship between the income statement and the balance sheet. (LO #6)

#### V. KEY TERM REVIEW

From the list of accounting terms below, fill in the blank spaces in the sentences that follow.

Financial accounting Accounting Financial statements Accrual accounting Fundamental accounting model Assets Generally accepted accounting principles (GAAP) Audit Income statement Balance sheet Liabilities Capital stock Managerial accounting Cash-basis accounting Market value Concept(s) Net income Conceptual framework of accounting Net loss CPA (certified public accountant) Principle(s) Dividend Retained earnings Equity Revenue **Expenses** SEC (Securities and Exchange Commission) FASB (Financial Accounting Standards Board) Statement of changes in retained earnings 1. The \_\_\_ is the financial statement reporting the profitability of a business entity during a specific period of time: the is the financial statement that summarizes the factors that altered retained earnings during the specific period of time; and the is the financial statement that provides information about an entity's resources and claims against those resources as of the end of a specific period of time. 2. An amount paid periodically by a corporation to its stockholders as a return on their invested capital is called a 3. The basic set of accounting rules consisting of both official pronouncements and uncodified accounting practices and procedures is called is a licensed public accountant trained to perform auditing, management consulting, and 4. A tax services. 5. The \_ is the federal agency established by Congress to regulate securities markets and to ensure effective public disclosure of accounting information. The is the private-sector rule-making agency whose pronouncements are a primary source of generally accepted accounting principles. consists of general concepts that derive from the objectives of financial reporting and from which generally accepted accounting principles are in turn derived. is an accounting proposition or rule that applies to specific situations, whereas a is a generalized accounting proposition that is applicable in a variety of contexts. 8. The component of equity in a business entity that represents accumulated profits in excess of losses and payments to owners is called \_\_\_\_ is the component of equity contributed by owners. 9. represent probable future economic benefits obtained or controlled by an entity; are probable future sacrifices of economic benefits; and represents the residual interest in the former after deducting the latter from the former. 10. An \_ is a detailed examination of an accounting system conducted by a CPA, who issues a written opinion as to the reasonableness of the financial statements under consideration. \_ is measured by the cash expended or the cash value of noncash assets, liabilities, or equity given in exchange for an asset. 12. The method of recording the activities of a business entity based on when the activities occur is called \_. An alternate method called \_\_\_\_\_ records the activities of a business entity only when the related amounts of cash are received or paid. 13. The total selling price of goods or services transferred by a business to its customers during a given period is called \_ are the outflows or other uses of assets during a period that result from the sale of goods or the provision of services by the entity. 14. The monetary worth attributed to an asset by the marketplace is referred to as 15. involves the preparation of financial information designed for use by managers and

for use in financial decision making. 17. The excess of an entity's total revenues over its total expenses during a period of time is called

\_ involves the identification, measurement, and communication of economic information

statements are prepared for use by stockholders, creditors, and other decision makers outside the entity.

\_\_\_\_ is the process by which financial

decision makers inside the business entity, whereas

16.

	. The excess of an entity's total expenses over its total revenues during a period of time, on the contrary, is called
18.	The reflects the relationship among assets, liabilities, and equity on the balance sheet through the equation Assets = Liabilities + Equity.
19.	
AN	SWERS TO KEY TERM REVIEW

- Income statement, statement of changes in retained earnings, balance sheet
- 2. Dividend
- 3. Generally accepted accounting principles (GAAP)
- 4. CPA (certified public accountant)
- SEC (Securities and Exchange Commission), FASB (Financial Accounting Standards Board)
- 6. Conceptual framework of accounting
- 7. Principle, concept
- 8. Retained earnings, capital stock
- 9. Assets, liabilities, equity

- 10. Audit
- 11. Cost
- 12. Accrual accounting, cash-basis accounting
- 13. Revenue, expenses
- 14. Market value
- 15. Managerial accounting, financial accounting
- 16. Accounting
- 17. Net income, net loss
- 18. Fundamental accounting model
- 19. Financial statements

#### VI. PRACTICE QUESTIONS, EXERCISES, AND PROBLEMS

#### Questions

- 1. Explain why accounting information can be characterized as user-oriented.
- 2. Identify and describe in summary form the three major groups within the accounting profession.
- 3. How are generally accepted accounting principles related to the independent audit of a business entity's financial statements?
- 4. Explain why the fundamental relationship among assets, liabilities, and equity is permanent.
- 5. Distinguish between the balance sheet and the income statement.

#### Exercises

- 6. Listed below are positions held by individuals within the accounting profession. Indicate in which group within the profession each belongs.
  - a. Controller, Farah, Inc.
  - b. Budget Officer, Oregon Department of Revenue
  - c. Audit Manager, Hutton & Gonzalez, CPAs
  - d. Internal Revenue Service Auditor
  - e. Treasurer, Salvation Army
- 7. The table below contains the most recent financial statement data for two business entities, A and B. Use your understanding of the relationship among the primary financial statements and among or between the components of the individual statements to determine the amount of the missing information.

PINIALA.	ENTITY	
FINANCIAL STATEMENT ITEM	A	В
Total revenue	5,000	\$3,500
Total expenses	2,000	
Not income (less)		2,000
Net income (loss)	(2.000)	
Total assets	10 000	0.000
Total liabilities	10,000	8,000
Equity		3,000
Capital stock	5 000	0.000
Retained earnings	5,000	2,000
Retained earnings	3,000	

- 8. a. Using the data for Entity A in Exercise 7, calculate the beginning balance of retained earnings, assuming that the amount of dividends paid during the period was \$1,500.
  - b. Using the data for Entity B in Exercise 7, calculate the amount of dividends paid during the period if the retained earnings balance at the beginning of the period was \$2,500.

#### **Problems**

9. Prepare a balance sheet in good form using the following accounts and amounts as determined at the close of business on October 31, 19X6, for Busby Company.

Accounts payable	
Accounts receivable	9,000
Cash	
Dividends	5,000
Income taxes payable	3,000
Interest payable	1,000
Land	25,000
Merchandise inventory	20,000
Capital stock	37,000
Rent payable	3,000
Retained earnings	?
Wages payable	2,000

10. Prepare an income statement in good form using the following accounts and amounts for Burns Company for 19X6.

Advertising expense	\$ 6.000
Depreciation expense	4,000
Dividends	8,000
Interest revenue	5,000
Income taxes expense (40% of income before taxes)	?
Rent expense	10,000
Retained earnings (beginning balance)	12,000
Service revenue	60,000
Wages expense	20,000

11. Prepare a statement of changes in retained earnings using the information in Problem 10.

#### VII. COMMON ERRORS

1. There exists just one "type" of accounting for a business entity. In order to identify, measure (in terms of money), and communicate economic information about an entity, an accounting system must be developed and maintained to keep records of financial activities and to summarize these activities into periodic financial reports. The type of information that a decision maker will require from these reports depends on the kind of decisions that the user must make. For example, taxing authorities (for example, the Internal Revenue Service) require periodic information about the amount of tax revenues available to finance capital and governmental programs. Management of an entity needs accounting information to make both day-to-day business decisions (for example, establishing production levels, setting reasonable selling prices) and long-range decisions (for example, dropping a product, expanding plant facilities). It is very unlikely that the accounting information prepared for taxing authorities will provide management with the information necessary to make these types of decisions, or vice versa. Investors and creditors outside the entity need accounting information that will assist them in making rational investment and credit decisions. Again, it is unlikely that the information useful to taxing authorities or to management will prove useful to investors and creditors in achieving their objectives. Since the information needs of these users differ, there is no reason to presume that a single set of accounting reports can universally satisfy these needs. Rather, the accounting system of an entity generates a variety of financial reports in order to be responsive to these different information needs. Thus, there exist different "types" of accounting-for example, income tax accounting, managerial accounting, and financial accounting—which are differentiated by the intended uses of the accounting information.

- 2. Failure to understand the need for generally accepted accounting principles and a conceptual framework of accounting. In their initial exposure to accounting, students often tend to believe that accounting is a naturally ordered and precise discipline. But accounting practices and procedures are not founded on natural scientific laws. Rather, accounting is based on human perceptions and evaluations of the economic behavior of individual entities and groups of entities. Since human perceptions and evaluations of essentially human behavior can differ, even among rational and reasonable observers, the accounting practices and procedures formulated on the basis of these perceptions and evaluations can also differ. In order to provide rational order and stability for accounting data and reports, some mechanism is needed to judge the relative merits of these alternative accounting treatments. This mechanism is, and has been, based on the notion of a "consensus" among observers as presently represented by the Financial Accounting Standards Board. The Financial Accounting Standards Board is the private-sector body that is responsible for formulating generally accepted accounting principles (making human judgments concerning competing practices and procedures) and for refining the overall conceptual framework of accounting (again, based solely on human judgments), from which these principles or standards are derived.
- 3. Failure to understand the relationships among the balance sheet, income statement, and statement of changes in retained earnings. When first introduced to the primary financial statements, students tend to study and learn about each statement individually, in isolation from the other statements. Failure to comprehend the whole of the financial reporting process as represented by the balance sheet, income statement, and statement of changes in retained earnings will be likely to hinder students in understanding the purposes served by the respective statements and result in an inability to prepare these financial statements.

For example, revenue from the sale of goods to customers will be reported as a positive element of net income in the income statement. The concurrent inflow of cash or receivables from the sale will be reported as an increase in assets in the balance sheet. According to the fundamental accounting model, assets must always equal the sum of liabilities and equities. Yet the inflow of assets from the sale has apparently not been matched by an increase in either liabilities or equities or a corresponding decrease in assets. This view fails to comprehend that the revenue from the sale increases net income in the income statement, which in turn increases retained earnings in the statement of changes in retained earnings. The ending balance of retained earnings, as calculated in that statement (including the increase in net income from revenue associated with the sale of goods), represents the retained earnings balance to be reported in the balance sheet. Thus, the fundamental accounting model is preserved, as it always will be.

- 4. The balance sheet is a statement of values. The balance sheet provides information about an entity's economic resources (assets) and the claims against those resources (liabilities and equity). There is an initial temptation to believe that assets are reported on the balance sheet in terms of their current value—what it would cost to replace the asset currently or the price for which the asset could be sold presently. Assets are reported in the balance sheet at their cost. Cost is measured by the amount of cash expended or the cash value of noncash assets, liabilities, or equities given in exchange for the asset. Cost is the only measure that is tenable in this discipline because what are being measured are historical events, the experiences of acquiring and giving (selling) goods and services. Moreover, the cost of an asset represents an actual bargained price between a rational buyer and a seller and is thus capable of being verified.
- 5. Equating revenues and expenses with cash inflows and outflows resulting from the sale of goods and services. It is not uncommon to consider that revenue is earned only when it results in a cash inflow. Conversely, expenses are not incurred until there has been a related cash outflow. This is representative of the cash-basis method of accounting; that is, reporting revenues and expenses in the income statement in the period in which cash inflows or outflows occur. The conventional financial accounting model employs accrual accounting, whereby revenues and expenses are reported in the period in which the accomplishment and related effort occur. For example, when an entity sells goods to customers on credit, revenue should be reported in the period of accomplishment (the sale of goods to customers), regardless of when the cash is collected from customers. Similarly, if office supplies are purchased from suppliers for cash, the expense for office supplies should be reported in the income statement in the period when the supplies are used (period of related effort) without regard to the period of cash payment to suppliers.
- 6. Retained earnings is a "fund" of cash. Retained earnings is defined as the accumulated profits in excess of losses and payments (dividends) to owners. In short, retained earnings represents that portion of total net income over the life of the entity that has been retained by the entity and is undistributed. Some students view retained earnings as a fund of cash maintained in a bank or in a safe on the entity's premises for the purpose of paying dividends to stockholders. Those who hold this view fail to understand that retained earnings, like liabilities and capital stock, represents a source of the assets to the entity. Although business operations (Revenues Expenses = Net income) may likely bring cash into the entity, that cash is then used to finance the acquisition of productive tangible and intangible assets, to pay off liabilities, and to pay dividends to stockholders. Thus, retained earnings is not identified with any specific asset but is embodied in the entire asset base of the entity.

#### VIII. POST-TESTS

#### Post-Test A

#### True-False

In the space provided, mark each of the following statements "T" if it is true or "F" if it is false.

 1.	Accounting is the process of identifying, measuring, and communicating economic information to permit
	informed judgments and decisions by users of the information.
 2.	Accountants in public practice provide accounting information related to taxation, budgeting, routine operating
	decisions, investment decisions, performance evaluation, and external financial reporting.
 3.	The Financial Accounting Standards Board is presently the authoritative source of generally accepted accounting
	principles.
 4.	Tangible assets are reported in the balance sheet at their estimated selling price.
 5.	Losses from unprofitable business operations will cause a decrease in the equity of an entity.

#### Multiple Choice

Circle the letter of the best answer in each of the following items.

- 1. Financial accounting is directed primarily to meeting the information needs of
  - a. federal, state, and local taxing agencies.
  - b. the Securities and Exchange Commission.
  - c. managers and other decision makers inside the business entity.
  - d. investors and creditors and other decision makers outside the business entity.
  - e. all of the above.
- 2. The principal reason for an audit of a business entity's financial statements by a certified public accountant is to
  - a. obtain an independent expert opinion as to the fairness and reasonableness of the application of generally accepted accounting principles.
  - b. detect fraud on the part of the accountants within the entity in preparing the financial statements.
  - c. assist the entity in preparing financial statements.
  - d. relieve management of the responsibility for financial reporting to investors and creditors and other decision makers outside the entity.
  - e. none of the above.
- 3. Which of the following financial statements would be dated "As of December 31"?
  - a. income statement
  - b. statement of cash flows
  - c. statement of changes in retained earnings
  - d. balance sheet
  - e. none of the above
- 4. Which of the following events represents revenue to the entity?
  - a. received \$100,000 from the issuance of common stock
  - b. collected \$520 on an account receivable
  - c. issued a one-year note payable for \$8,000
  - d. rented the use of its parking lot to a flea market for \$25
  - e. all of the above
- 5. Given the interrelationship among the primary financial statements and the content of each statement, what appears to be the proper sequence of preparation of the statements?
  - a. balance sheet, statement of changes in retained earnings, income statement
  - b. statement of changes in retained earnings, income statement, balance sheet