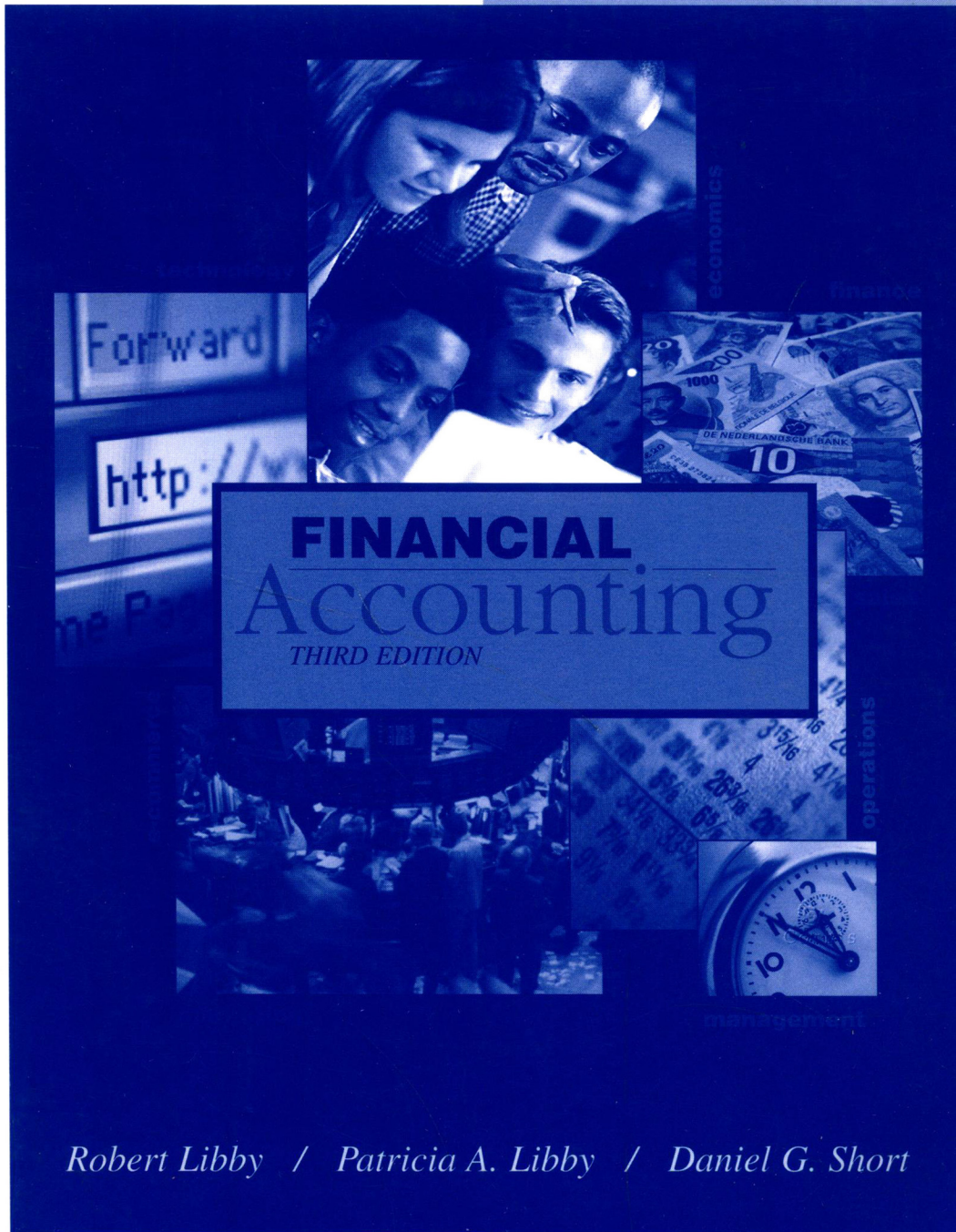


# Study Guide

for use with



Prepared by  
Jeannie M. Folk

# Study Guide

for use with

# Financial Accounting

Third Edition

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FINANCIAL ACCOUNTING  
Robert Libby, Patricia A. Libby, Daniel G. Short

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## PREFACE

This Study Guide was developed to help you study more effectively. It incorporates many of the accounting survival skills essential to your success. It is designed to accompany the second edition of *Financial Accounting* by Libby, Libby and Short, but is not a substitute for your textbook. Each chapter of the Study Guide contains the following sections: *Organization of the Chapter*, *Chapter Focus Suggestions*, *Learning Objectives*, *Read and Recall Questions*, *Chapter Take-Aways*, *Key Ratio*, *Finding Financial Information*, *Self-Test Questions and Exercises*, *Solutions to Self-Test Questions and Exercises*, and *An Idea for Your Study Team*.

### **AN ACCOUNTING SURVIVAL PLAN (Preview, Read & Recall, Practice & Apply, Review)**

#### ✓ **Preview**

Before you read a chapter in the textbook, preview it. Start by reading the *Organization of the Chapter*, *Learning Objectives* and *Chapter Focus Suggestions* sections that appear at the beginning of each chapter in this Study Guide. Next, thumb through the chapter in the textbook, noting the names of each of the section headings. Finally, read the textbook chapter summary and key terms list.

#### ✓ **Read & Recall**

Now that you know what to expect, start reading. As you finish reading each section of the chapter in the textbook, answer the related *Read and Recall Questions* included in the Study Guide. Check your answers by referring to the related section in your textbook. If you were not able to answer all of the questions, read the related section of the chapter in your textbook again. When you can answer the *Read and Recall Questions*, you understand and can recall what you just read. To move that information into long-term memory, you'll need to practice and apply what you have learned.

#### ✓ **Practice & Apply**

After reading the *Chapter Take-Aways*, *Key Ratio* and *Finding Financial Information* sections of the Study Guide, practice and apply what you have learned by completing the *Self-Test Questions and Exercises*. Test your vocabulary skills by matching the key terms with the textbook definitions. Answer each of the true-false and multiple choice questions, and check your answers in the *Solutions to Self-Test Questions and Exercises* section. Complete each of the exercises. Feel free to check an answer to one part of an exercise with the *Solutions* before moving on to another part.

#### ✓ **Review**

Use the Study Guide on a daily basis as you prepare for exams. The *Read and Recall Questions*, *Chapter Take-Aways* and *Key Ratio* sections can be used to review the essential concepts covered in each chapter. The *Self-Test Questions and Exercises* are likely to be similar to the materials you will encounter on exams.

Remember that you're not alone. Develop your own support system by forming a study team with three or four of your classmates. Each chapter of the Study Guide contains an *Idea for Your Study Team*. You'll learn by discussion, and develop valuable interpersonal skills.

Don't forget to use positive self-talk as you visualize your success in this accounting class. You can do it!

I would appreciate your comments and suggestions.

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*I could not fulfill my roles as a teacher and author  
without the support of my children,  
Andy, Jessica & Kevin.*

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# CHAPTER 1

## FINANCIAL STATEMENTS AND BUSINESS DECISIONS

### ORGANIZATION OF THE CHAPTER

<i>Information Conveyed in Financial Statements</i>	<i>Responsibilities for the Accounting Communication Process</i>
Overview	Generally Accepted Accounting Principles
The Balance Sheet	Management Responsibility and the Demand for Auditing
The Income Statement	Ethics, Reputation, and Legal Liability
Statement of Retained Earnings	
Statement of Cash Flows	
Notes	
Using Financial Statements to Estimate the Value of Maxidrive	
Price/Earnings Ratio	

### CHAPTER FOCUS SUGGESTIONS

#### *Overview*

This chapter describes the process that businesses use to communicate financial information to investors and creditors.

#### *Terminology*

If you have not yet worked in a business setting, you most likely will not be familiar with many of the terms used in this chapter. A listing of key terms appears at the end of the chapter; you should learn the definitions of each of these key terms. However, you should also make sure that you are familiar with the other terms that are used in this chapter. These terms will be used throughout this course. As such, a solid understanding of the terminology used in this chapter is essential to your success.

#### *Financial Statement Matters*

Four basic financial statements (that is, the income statement, statement of retained earnings, balance sheet and statement of cash flows) are used to communicate financial information to decision makers. This chapter provides an overview of each of the four basic financial statements. Memorize the equations for the financial statements so that you are able to easily identify the categories of items that are reported on each. Practice preparing all four financial statements. You will also be expected to understand how the financial statements are interrelated. As such, take the time to trace the common numbers from one financial statement to the next as you prepare the financial statements for a given company.

This chapter also introduces the parties involved in the communication process. Knowing which items are reported on each financial statement will help you to understand how decision makers use the financial statements.



## **Learning Objectives**

*After studying this chapter, you should be able to:*

- (LO 1) Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).
- (LO 2) Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.
- (LO 3) Distinguish the roles of managers and auditors in the accounting communication process.
- (LO 4) Appreciate the importance of ethics, reputation, and legal liability in accounting.

## **READ AND RECALL QUESTIONS**

*After you read each section of the chapter, answer the related Read and Recall Questions set forth below.*

### **LEARNING OBJECTIVE**

*After studying this section of the chapter, you should be able to:*

1. Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

## **THE OBJECTIVES OF FINANCIAL ACCOUNTING**

What is the purpose of the Libby, Libby & Short *Financial Accounting* textbook? Which groups of readers is the book aimed at? What do you expect to learn in this accounting course?

## **BUSINESS BACKGROUND**

What do owners (often called investors or stockholders) hope to gain when they purchase a company? What risks do they assume? Why do creditors lend money to businesses? What do they hope to gain? What risks do they assume?

What functions are performed by Maxidrive's accounting system? What two major groups use the reports produced by this accounting system?

How does managerial or management accounting differ from financial accounting? Which of the two is the focal point of this text?

## **INFORMATION CONVEYED IN FINANCIAL STATEMENTS**

What did Exeter Investors (Maxidrive's new owner) and American Bank (Maxidrive's largest creditor) use to learn more about the company before making their purchase and lending decisions? What assumption did they make when they used this information to make their purchase and lending decisions?

### **Overview**

What three questions should be addressed as you are becoming familiar with the general structure and content of each of the four basic financial statements?

### **The Balance Sheet**

What four significant items are found in the heading of a balance sheet? What is the purpose of the balance sheet? What is another name for the balance sheet? What is the time dimension of the balance sheet? What unit of measure is used to prepare financial statements of U.S. companies?

What is the separate entity assumption?

### **Assets**

Cash, accounts receivable, inventories, plant and equipment and land are listed as assets on Maxidrive's balance sheet. What is an asset? How are assets initially measured on the balance sheet? What is the cost principle?

### **Financial Analysis – Interpreting Assets on the Balance Sheet**

Why did American Bank and Exeter assess Maxidrive's assets? Why are assets so important? If Maxidrive goes out of business, can its assets be sold for the amounts listed on its balance sheet?

## **Liabilities And Stockholders' Equity**

What is a liability? How do liabilities arise? What are accounts payable? What does "on open account" mean?

## **Financial Analysis – Interpreting Liabilities on the Balance Sheet**

If Maxidrive is not able to pay its debts, what action can its creditors take?

What are the two sources of stockholders' equity? What is the meaning of the term "retained earnings?"

## **Financial Analysis – Interpreting Stockholders' Equity on the Balance Sheet**

What is another term for stockholders' equity? Why is the amount of Maxidrive's stockholders' equity so important to American Bank? Does the amount of stockholders' equity represent the market value of a company as a whole to its owners? Why or why not?

What characteristic is used to determine the order of assets on the balance sheet? How are liabilities ordered?

## **The Income Statement**

What is the time dimension of the income statement? What is an accounting period? What other names are given to the income statement? What are the three major captions found on the income statement? What is the income statement equation?



## **Revenues**

What are revenues? When should revenues be reported on the income statement? Does the receipt of cash from a customer always coincide with the recording of revenue? Why or why not?

## **Expenses**

What do expenses represent? When are expenses reported on the income statement? Is it appropriate to correlate the recording of an expense with the payment of cash for that expense? Why or why not?

## **Net Income**

What is net income? What other terms are used to describe net income? What term is used if total expenses exceed total revenues? What term is used when total revenues equal total expenses?

## **Financial Analysis – Analyzing the Income Statement: Beyond the Bottom Line**

Why do investors (such as Exeter) and creditors (such as American Bank) closely monitor a firm's net income?

## **Statement of Retained Earnings**

What information is reported on the statement of retained earnings? What is the time dimension of the statement of retained earnings? Does net income increase or decrease the balance of retained earnings? Does the declaration of dividends increase or decrease the balance of retained earnings? What is the retained earnings equation?

## **Financial Analysis – Interpreting Retained Earnings**

What is an important source of financing for companies (such as Maxidrive)? Why do creditors (such as American Bank) closely monitor a firm's retained earnings statement?

## **Statement of Cash Flows**

Why aren't reported revenues always equal to the amount of cash collected from customers? Why aren't reported expenses always equal to the cash paid out during the period?

What is the purpose of the statement of cash flows? What is the time dimension of this statement? What are the three primary categories of cash flows in a typical business?

## **FOCUS ON CASH FLOWS: Statement of Cash Flows Classifications**

What is meant by cash flows from operating activities? What is meant by cash flows from investing activities? What is meant by cash flows from financing activities? What is the cash flow statement equation?

## **Financial Analysis – Interpreting the Cash Flows Statement**

What do analysts believe regarding the usefulness of the statement of cash flows? Which section of the statement do bankers consider the most important?

## **Notes**

Why are the notes (or footnotes) to the financial statements so important? What type of information is provided by each of the three types of notes to the financial statements?

## **Financial Analysis – Management Uses of Financial Statements**

How do the managers of a company (or firm) make direct use of the firm's financial statements?

### **The Fraud**

What three types of errors did Exeter find in Maxidrive's financial statements?

### **Determining the Purchase Price for Maxidrive**

What factors did Exeter consider when deciding on a purchase price for Maxidrive? What is one method that is used to estimate the value of a company? What three steps should be performed in ratio analysis?

### **Key Ratio Analysis: Price/Earnings Ratio**

How is the price/earnings (PE) ratio computed? What does the P/E ratio measure? All others things equal, what does a high P/E ratio mean?

#### **LEARNING OBJECTIVE**

*After studying this section of the chapter, you should be able to:*

2. Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.

#### **RESPONSIBILITIES FOR THE ACCOUNTING COMMUNICATION PROCESS**

What does the decision maker need to understand before using accounting information? What is the name of the measurement rules that are used to develop accounting information? What is meant when accounting numbers are described as being meaningful?



## **Generally Accepted Accounting Principles**

Why were the Securities Exchange Acts of 1933 and 1934 passed by Congress? What function does the Securities and Exchange Commission (SEC) perform? What group has the primary responsibility to work out the detailed rules that become generally accepted accounting principles (GAAP)?

## **Why Do Managers, Accountants and Users Care What is Generally Accepted?**

Companies incur the cost of preparing financial statements and bear the major economic consequences of their publication. What are the three major potential economic consequences?

## **International Perspective**

Is there one set of generally accepted accounting principles in use throughout the world? What is the International Accounting Standards Board attempting to accomplish? Until their goal is reached, what must managers and users do in order to successfully interpret financial statements?

### **LEARNING OBJECTIVE**

*After studying this section of the chapter, you should be able to:*

3. Distinguish the roles of managers and auditors in the accounting communication process.

## **MANAGEMENT RESPONSIBILITY AND THE DEMAND FOR AUDITING**

Who has the primary responsibility for the information that is presented in a company's financial statements? What steps do managers take to ensure the accuracy of the company's records?

What is the role of an independent auditor? What is the purpose of an audit? What does an independent CPA do while performing an audit? What doesn't the CPA do?

**LEARNING OBJECTIVE**

*After studying this section of the chapter, you should be able to:*

4. Appreciate the importance of ethics, reputation, and legal liability in accounting.

**ETHICS, REPUTATION AND LEGAL LIABILITY**

What is necessary if financial statements are to be of any value to decision makers?

Why do independent auditors adhere to a professional code of ethics? (Hint: There are at least two reasons.) What are the CPA's most important assets? What is the consequence of malpractice in the audit function?

**CHAPTER SUPPLEMENT A** *(Determine whether you are responsible for this supplement.)***Types of Business Entities**

What is a sole proprietorship? What is a partnership? What is a corporation? What are the characteristics of each of the three types of business? What is the dominant form of business organization in the United States? Why is it the dominant form?

**CHAPTER SUPPLEMENT B** *(Determine whether you are responsible for this supplement.)***Employment in the Accounting Profession Today**

What requirements must be met before an accountant may be licensed as a Certified Public Accountant? What are the three types of services performed by accounting firms?

What types of functions do accountants employed by profit-making and nonprofit organizations perform?

## **CHAPTER TAKE-AWAYS**

1. ***Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).***

The *balance sheet* is a statement of financial position that reports dollar amounts for the assets, liabilities, and stockholders' equity at a specific point in time. The *income statement* is a statement of operations that reports revenues, expenses, and net income for a stated period of time. The *statement of retained earnings* explains changes to the retained earnings balance that occurred during the reporting period. The *statement of cash flows* reports inflows and outflows of cash for a specific period of time. The statements are used by investors and creditors to evaluate different aspects of the firm's financial position and performance.

2. ***Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.***

Generally accepted accounting principles (GAAP) are the measurement rules used to develop the information in financial statements. Knowledge of GAAP is necessary for accurate interpretation of the numbers in financial statements.

3. ***Distinguish the roles of managers and auditors in the accounting communication process.***

Management has primary responsibility for the accuracy of a company's financial information. Auditors are responsible for expressing an opinion of the fairness of the financial statement presentations based on their examination of the reports and records of the company.

4. ***Appreciate the importance of ethics, reputation, and legal liability in accounting.***

Users will have confidence in the accuracy of financial statement numbers only if the people associated with their preparation and audit have reputations for ethical behavior and competence. Management and auditors can also be held legally liable for fraudulent financial statements and malpractice.

## **KEY RATIO**

Price/earnings ratio (P/E ratio; price/earnings multiplier) measures the relationship between current market price of a company and its net earnings and is a measure of expected company growth. It is computed as follows:

Market price ÷ Net income

## **FINDING FINANCIAL INFORMATION**

### **Balance Sheet**

*Assets = Liabilities + Stockholders' Equity*

### **Income Statement**

*Revenues*  
*– Expense*  
*Net Income*

### **Statement of Retained Earnings**

*Retained Earnings, beginning of the period*  
*+ Net Income*  
*– Dividends*  
*Retained Earnings, end of the period*

### **Statement of Cash Flows**

*Cash Flow from Operating Activities*  
*+ Cash Flow from Investing Activities*  
*+ Cash Flow from Financing Activities*  
*Net Change in Cash*



## **SELF-TEST QUESTIONS AND EXERCISES**

### **MATCHING**

*Match each of the key terms listed below with the appropriate textbook definition:*

___ Accounting	___ Generally accepted accounting principles
___ Accounting entity	___ Income statement
___ Accounting period	___ Report of independent accountants
___ Audit	___ Report of management
___ Balance sheet	___ Securities and Exchange Commission
___ Basic accounting equation	___ Statement of cash flows
___ Financial Accounting Standards Board	___ Statement of retained earnings
___ Notes (footnotes)	

- A. A report that indicates management's primary responsibility for financial statement information and the steps taken to ensure the accuracy of the company's records.
- B. A statement that reports the revenues less the expenses of the accounting period.
- C.  $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ .
- D. Supplemental information about the financial condition of a company, without which the financial statements cannot be fully understood.
- E. The organization for which financial data are to be collected (separate and distinct from its owners).
- F. The U.S. government agency that determines the financial statements that public companies must provide to stockholders and the measurement rules that they must use in producing those statements.
- G. A system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.
- H. The private sector body given the primary responsibility to work out the detailed rules that become generally accepted accounting principles.
- I. An examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles.
- J. A statement that reports the financial position (assets, liabilities, and stockholders' equity) of an accounting entity at a point in time.
- K. The measurement rules used to develop the information in financial statements.
- L. A report that describes the auditors' opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.
- M. A statement that reports inflows and outflows of cash during the accounting period in the categories of operations, investing, and financing.
- N. The time period covered by the financial statements.
- O. A statement that reports the way that net income and the distribution of dividends affected the financial position of the company during the accounting period.