

**STUDY GUIDE AND FORMS**

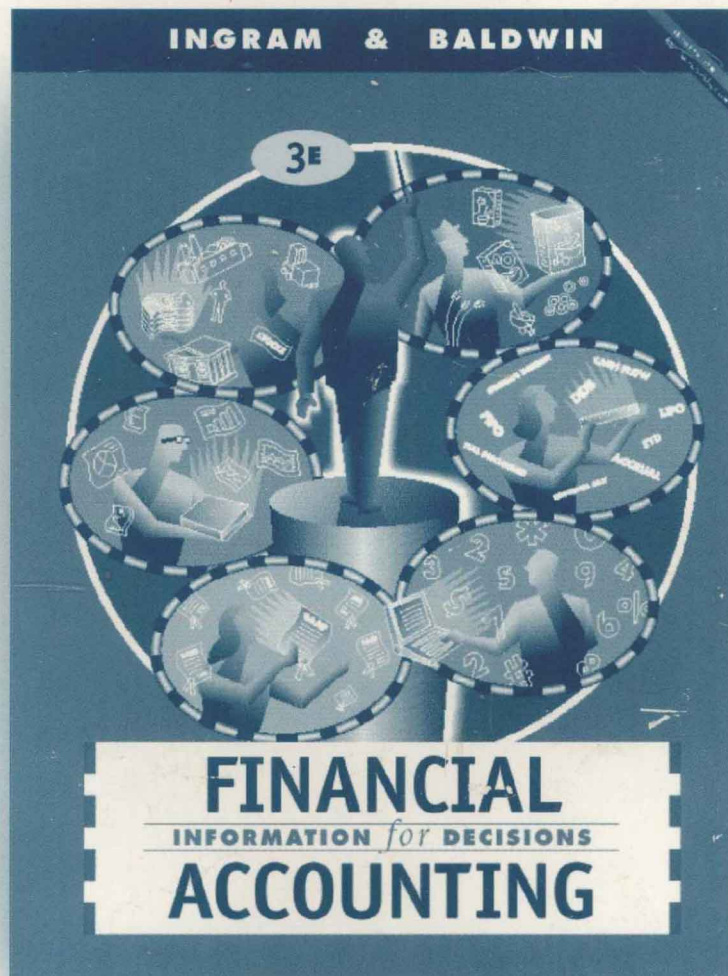
# **FINANCIAL**

---

**INFORMATION *for* DECISIONS, 3E**

---

# **ACCOUNTING**



**INGRAM & BALDWIN**

PREPARED BY  
**STEPHEN V. SENGE & GEORGE D. SANDERS**

**STUDY GUIDE AND FORMS**

# **FINANCIAL**

**INFORMATION** *for* **DECISIONS, 3E**

# **ACCOUNTING**

Robert W. Ingram  
*University of Alabama*

Bruce A. Baldwin  
*Arizona State University – West*

*Prepared by*  
Stephen V. Senge  
*Western Washington University*

George D. Sanders  
*Western Washington University*



SOUTH-WESTERN College Publishing

*An International Thomson Publishing Company*

Accounting Team Director: Richard Lindgren  
Senior Acquisitions Editor: David L. Shaut  
Developmental Editor: Sara E. Bates  
Production Editor: Peggy A. Williams  
Cover Design: Tin Box Studio  
Cover Illustration: John Bleck  
Marketing Manager: Matthew Filimonov

Copyright © 1998  
by South-Western College Publishing  
Cincinnati, Ohio

**ALL RIGHTS RESERVED**

The text of this publication, or any part thereof, may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, storage in an information retrieval system, or otherwise, without the prior written permission of the publisher.

ISBN: 0-538-87064-8

1 2 3 4 5 6 7 8 9 PN 5 4 3 2 1 0 9 8 7

Printed in the United States of America



International Thomson Publishing

South-Western College Publishing is an ITP Company. The ITP trademark is used under license.

## TABLE OF CONTENTS

### **Part 1: Study Guide: Chapter Reviews, Exercises, and Solutions**

#### ***Section I: The Accounting Information System***

<b>Chapter 1: Accounting and Organizations</b>	<b>1</b>
<b>Chapter 2: Information in Organizations</b>	<b>22</b>
<b>Chapter 3: Accounting Measurement</b>	<b>42</b>
<b>Chapter 4: Processing Accounting Information</b>	<b>63</b>
<b>Chapter 5: Reporting Accounting Information</b>	<b>84</b>
<b>Chapter 6: Reporting Accruals and Cash Flows</b>	<b>107</b>

#### ***Section II: Analysis and Interpretation of Financial Accounting Information***

<b>Chapter 7: The Time Value of Money</b>	<b>126</b>
<b>Chapter 8: Financing Activities</b>	<b>148</b>
<b>Chapter 9: Analysis of Financing Activities</b>	<b>169</b>
<b>Chapter 10: Investing Activities</b>	<b>190</b>
<b>Chapter 11: Analysis of Investing Activities</b>	<b>214</b>
<b>Chapter 12: Operating Activities</b>	<b>233</b>
<b>Chapter 13: Analysis of Operating Activities</b>	<b>257</b>

### **Part 2: Forms**

## SECTION I: THE ACCOUNTING INFORMATION SYSTEM

### CHAPTER 1: ACCOUNTING AND ORGANIZATIONS

**Introductory Note to Students:** As you begin your study of accounting, please consider the following ideas:

- Accounting makes important contributions to all phases of the transformation process that converts resources into goods and services. This major theme along with related concepts and techniques can assist individuals in many different situations.
- The introductory study of accounting is not just calculations. The authors of both the textbook and **Study Guide** integrate underlying concepts, important vocabulary, and specific quantitative analysis to provide an introductory view appropriate for a wide variety of students.
- *Active learning* should be a big part of your overall study plan. Answering self-study questions in the text; working homework problems; researching, discussing, and presenting projects; and completing the questions and exercises in the **Study Guide** reinforce the learning that begins with reading and listening.
- This **Study Guide** reviews major concepts of each chapter and provides exercises for practice. Each chapter of the **Study Guide** includes a chapter focus; a chapter outline; review questions, exercises, and short essays; and suggested answers. In this introductory chapter shaded boxes provide explanations of these components.

#### **Chapter Focus**

The **Chapter Focus** contains the major theme, important elements, and specific learning objectives for the chapter. This is a key section which describes important vocabulary, skills, and concepts you should know when you finish studying the chapter. This section can be used as both a preview (to see what's coming up) and a final checklist (to be sure you have covered everything).



**Major Theme:** Accounting is a system that provides information for making decisions about organizations.

**Important Elements:** As you study the chapter, look for the following major topics:

- An illustration of the accounting process
- The purposes and functions of organizations
- Decisions made in organizations
- The role of accounting in making decisions about organizations

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

- |                             |   |
|-----------------------------|---|
| <b>Identify:</b>            | The purpose of accounting.<br>Financing activities and the types of decisions they require.<br>Investing activities and the types of decisions they require.<br>Operating activities and the types of decisions they require. |
| <b>Explain:</b>             | Why accounting is an information system.<br>Why owners invest in businesses.<br>Why accounting information is useful to investors.  |
| <b>Compare and Explain:</b> | Major types of organizations and their purpose.   |
| <b>Describe:</b>            | The steps in an organization's transformation process.  |
| <b>Define:</b>              | Accounting.   |

## **Chapter Review**

The **Chapter Review** presents important concepts in a sentence outline form. This section reviews the chapter and places the vocabulary and ideas in an organized pattern.

**Introduction.** Accounting is a system that produces information useful in making decisions about organizations. This chapter establishes fundamental vocabulary and concepts that serve as foundations for further study. Major topics include the role of information in decisions, the accounting process, the purpose of organizations, decisions in organizations, a summary of the transformation process, and a definition of accounting.

1. **Information for Decisions.** Various forms of information such as facts, ideas, and concepts assist in understanding situations. More specifically, accounting information assists decision makers in evaluating economic choices.
  - A. Virtually all components of accounting information are measurable in monetary terms.
    1. In many cases, decision makers use accounting information to assess the level of risk or uncertainty involved in a specific course of action.
    2. Decision makers also use accounting information to measure an organizations' profit.
  - B. Overall, accounting provides a model of a business by measuring business activities in monetary terms.
2. **The Accounting Process.** Economic decisions involve choices about resource allocation, and the accounting process helps managers and investors understand the possible consequences of economic decisions.
  - A. The accounting process has two major components.
    1. Accounting records provide basic financial information about specific economic events. (A check register for a personal checking account is a good example of a basic accounting record.)
    2. Accounting reports summarize groups of specific accounting records and provide an overall view for decision makers. (A checking account report that displays a beginning balance, total deposits, total withdrawals, and an ending balance is an example of an accounting report.)
  - B. An accounting system includes several steps that process information from accounting records and provide accounting reports.

1. An account is an accounting record designed to track increases or decreases in a specific category of activity. For example, a cash account would track all cash increases and decreases while a land account would track all the purchases and sales of land.
2. A transaction is an economic event which changes various account balances. For example, the purchase of land for cash is an economic event, or transaction, that effects both the cash and land accounts.

**[Important Note: *Transactions* are events or activities in the life of an individual or organization. These transactions affect accounting records, or *accounts*, that track the financial impact of activities.]**

3. By providing a mechanism for recording, summarizing, and reporting economic information, an accounting system serves decision makers.
- C. Broadly speaking, organizations are groups of people who develop, produce, and/or distribute goods or services. Many stakeholder groups of any organization can and should use accounting information. Owners, creditors, employees, suppliers, customers, communities, and governmental may all have a direct or indirect economic interest in an organization.

3. **The Purpose of Organizations.** Organizations may be categorized using several different criteria.

- A. One important criterion is profit objectives. Business organizations sell their goods and services with the expectation of earning a profit. Alternatively, governmental and nonprofit organizations provide goods or services without the profit expectation.
- B. A second criterion is the specific nature of activities. Merchandising organizations purchase finished products and resell them to other organizations or individuals. Manufacturing organizations purchase raw materials and produce finished goods. Service organizations do not sell goods at all; they provide needed services such as financial, legal, public safety, or educational services to other organizations and individuals.



- C. To be successful, all organizations must create value by transforming resources from their most basic form to a different form which society considers more valuable. This transformation process involves transactions in markets, and an accounting measure for the increased value an organization provides is the difference between the total price of goods and service sold by an organizations and the organization's cost for resources used in the transformation process.
- D. The difference between the resources created and the resources consumed represents profit. In equation form, this relationship is:

$$\text{Resources Created} - \text{Resources Consumed} = \text{Profit.}$$

- 1. Owners invest in a business in order to receive a return on their investment in the form of profit. Return on investment is:

$$\text{Profit} \div \text{Amount Invested} = \text{Return on Investment}$$

This calculation provides a percentage measure of an organization's profitability. Profits may be distributed to owners or kept in the business. Either way, the owners benefit.

- 2. Distributed profits are paid to owners for their personal use. Undistributed profits are retained or reinvested in the business to enhance the opportunities for greater profitability.
  - E. Decisions about initial investments or reinvesting undistributed profits involve risk about the return that might be achieved.
  - F. Effective businesses successfully provide goods and services demanded by the public. Efficient businesses provide those goods and services at a low enough cost to assure profits. Accounting information helps investors assess both the effectiveness and efficiency of a firm.
- 4. **Decisions in Organizations.** Stakeholders make decisions about three general types of organizational activities: financing activities, investing activities, and operating activities.

- A. Financing activities include decisions and transactions designed to obtain and manage financial resources. Financial resources may be provided by either owners or creditors (or in many cases both).
1. The specific process of financing through owners depends upon the legal form of organization.
    - a) A corporation is a legal entity independent from any of its owners. Investors purchase shares of stock or shares of ownership in a corporation. These shares allow shareholders to vote on major decisions and share in any profit of the corporation.
    - b) Proprietorships or partnerships do not have legal status separate from the owners of these organizations. Owners still contribute resources to these organizations and have a stake in organizational decisions and financial success.
    - c) Corporations have several specific advantages over proprietorships or partnerships.
      - (1) They have continuous lives, limited liability, professional management, and the ability to raise large amounts of capital.
      - (2) In addition, shareholders need not be concerned with mutual agency – the right of a partner to enter into contracts that bind all the other partners.
    - d) Corporations also have disadvantages when compared with proprietorships or partnerships.
      - (1) They must pay taxes on their incomes, comply with costly regulations, and make audited financial disclosures.
      - (2) Corporations may be difficult to manage due to their large size.
      - (3) Shareholders do not usually have access to the same level and detail of information as those individuals who actually manage the firm.

- (a) This creates a moral hazard situation. Moral hazards are conditions where agents -- the managers -- may use their superior information to benefit themselves more than the principals -- the shareholders.
  - (b) To control this moral hazard, managers are required to make frequent reports to shareholders.
- 2. Financing from creditors, or lenders, comes in the form of loans or other forms of debt. Creditors expect to receive both the repayment of the amount loaned and interest payments.
- 3. Financing decisions involve managerial choices about the amount of resources required as well as the specific sources of financing and the resulting obligations of the organization.
- B. Investing activities include the selection and management of specific resources which assist in the development, production, and sales of goods and services. These resources include land, buildings, equipment, and legal rights such as patents. Investing decisions involve the amounts of specific resources that will be acquired and their control.
- C. Operating activities include the use of resources to develop, produce, and distribute goods and services. These day-to-day operating activities include research and development, design and engineering, purchasing, human resource management, production, distribution, marketing and selling, and providing customer service.

**[Important Note: The nature of financing, investing, and operating activities is a major theme running throughout this introduction. Remember that managers within an organization must be engaged in all three phases:**

**Financing Activities: Acquiring financial capital.**

**Investing Activities: Using the financial capital to acquire various types of resources.**

**Operating Activities: Using the resources to develop, produce, and distribute products and services.]**

5. **Summarizing the Transformation Process.** Each organization performs some type of transformation process which includes the acquisition of capital (financing activities), the acquisition of people, equipment, and other resources (investing activities), and the use of these various resources to develop, produce, and distribute goods and services (operating decisions).
6. **Definition of Accounting.** Accounting is an information system which assists managers as they make financing, investing, and operating decisions within an organization's transformation process. Specifically, accounting measures and reports the various transactions that form the transformation process.
7. **Appendix: Accounting as a Profession.** The accounting profession includes accountants who work in businesses, public accounting firms, governmental and nonprofit organizations, and educational institutions.
  - A. Management accountants provide all accounting functions within business organizations. These activities include accounting systems development and management, financial reporting, financial planning and analysis, cost accounting and cost management, and internal auditing.
  - B. Public accountants provide independent auditing, tax advisory, and consulting services to businesses, nonprofit organizations, and individuals. Independent audit services may only be performed by a Certified Public Accountant (CPA).
  - C. Accountants in governmental and nonprofit organizations provide services such as accounting systems support and the preparation and interpretation of financial reports for their organizations.
  - D. Accounting educators engage in both teaching and research activities related to accounting.

**Review Questions, Exercises, and Short Essays**

The **Review Questions, Exercises, and Short Essays** section presents questions and exercises for practice. Success in the multiple choice questions, exercises, and short essays is an important indication of mastery of the content of the chapter. Suggested answers appear at the end of the chapter.

Multiple Choice Questions: These questions reinforce vocabulary and basic concepts from the chapter. In each case, select the answer you believe to be the *best*.

1. The purpose of accounting is to help people make decisions about:
  - a. Profit-seeking business only.
  - b. Economic activities in general.
  - c. Risk of investments.
  - d. Investment returns to shareholders.
2. Accounting systems measure activities in terms of:
  - a. Local currency.
  - b. Metric units.
  - c. Various quantities.
  - d. When they happen.
3. Return on investment is a term that refers to:
  - a. The dollar amount that is paid to investors.
  - b. Another expression for interest.
  - c. The returning of an investors funds when an investment matures.
  - d. A measure that provides information about the profitability of an investment.
4. Risk, in financial decisions, refers to:
  - a. The *possibility* that an investment will not earn a return.
  - b. The *likelihood* that an investment will not earn a return.
  - c. Uncertainty about an outcome.
  - d. Any investment, because they are all risky.
5. An information system can be broadly described as:
  - a. A set of computers and computer terminals used to provide information.
  - b. A set of interrelated activities that are coordinated to record, summarize, and report information.
  - c. An organizational unit that provides reports to those asking for information.
  - d. A completed set of financial reports.



6. The basic information unit in an accounting system is:
  - a. An account.
  - b. A transaction.
  - c. A company.
  - d. An operating department within any organization.
7. Those who have an economic interest in an organization and who are affected by the activities of the organization are known as:
  - a. Stockholders.
  - b. Stakeholders.
  - c. Employees.
  - d. Owners.
8. Organizations create value by:
  - a. Transforming less desirable resources into more desirable resources.
  - b. Selling goods and services only.
  - c. Using labor to produce goods and services.
  - d. Researching customer preferences.
9. In a broad economic sense, a market is:
  - a. A large store.
  - b. Any physical location where goods and services are bought and sold.
  - c. A process that permits the exchange of goods and services.
  - d. None of the above.
10. Markets can be classified by the types of goods and service exchanged. Important market types are:
  - a. Financial markets.
  - b. Supplier markets.
  - c. Product markets.
  - d. All of the above.
11. Price is regarded as an important piece of information in a market economy because:
  - a. It describes inflation.
  - b. The higher that prices are, the less people will buy.
  - c. It represents the value agreed to between a willing buyer and willing seller at a particular point in time.
  - d. It measures business profit.

12. An accounting measure of the value resulting from transformations is:
  - a. Price of resources.
  - b. Cost of resources.
  - c. Selling price of resources produced minus the cost of resources used.
  - d. Cash Received.
13. *Revenues* are:
  - a. Sales prices of goods and services.
  - b. Cash collected from customers.
  - c. The amount of profit earned.
  - d. Investments by owners.
14. *Financing decisions* are choices made about alternative:
  - a. Sources of financial resources.
  - b. Types of business organizations.
  - c. Resources that will be used in the transformation process.
  - d. Nonfinancial resources that will be required by the business.
15. *Operating activities* may include:
  - a. Borrowing money for a new transportation facility.
  - b. Human resource management.
  - c. Issuing new shares of stock and selling them to investors.
  - d. Acquiring a building.

Exercises: These questions require the analysis of economic situations and application of accounting concepts.

1. Calculating Profit. Ann James invested \$20,000 in a business selling in-line skates and accessories. She opened a bank account in her business' name and began to look for a location and inventory to sell. During her first month, she engaged in the following transactions:
  - a. Rented space in a downtown building and paid \$1,500 for the first month's rent.
  - b. Purchased inventory for \$5,000 and sold this merchandise for \$8,000.
  - c. Paid a sales assistant \$400 for two weeks of work.
  - d. Paid an electric bill for \$250.
  - e. Paid taxes of \$560.
  - f. Paid for \$250 of supplies that were used.

What is Ann's profit for the month? (Hint: Prepare a statement of profit earned similar to text Exhibit 9.) Do you think she has been successful? Why or why not?

2. Identifying Financing, Investing, and Operating Decisions. Tom Robinson, an avid kayaker and fly-fisher has decided that he will turn his hobbies into a career by opening a kayak and fly-fishing business in the San Juan Islands. He realizes that he will need a business plan and that he will need to make a number of decisions:
- a. For tax and legal reasons, Tom plans to incorporate the business. He will deposit \$10,000 of his own money in a checking account in the name of the business and will be the sole shareholder.
  - b. He develops a detailed list of equipment and estimates that it will cost \$20,000.
  - c. Tom has approached a local banker who has indicated a willingness to lend another \$10,000 to the business.
  - d. Tom feels that he will need another \$5,000 for supplies and cash on hand for unforeseen events. He will take a loan from a credit union in his own name and lend the money to his business with the intention that the business will repay the loan with interest.
  - e. Tom will need some clerical assistance. He plans to hire a part-time bookkeeper.

Identify each of Tom's decisions as a financing, investing, or operating decision.