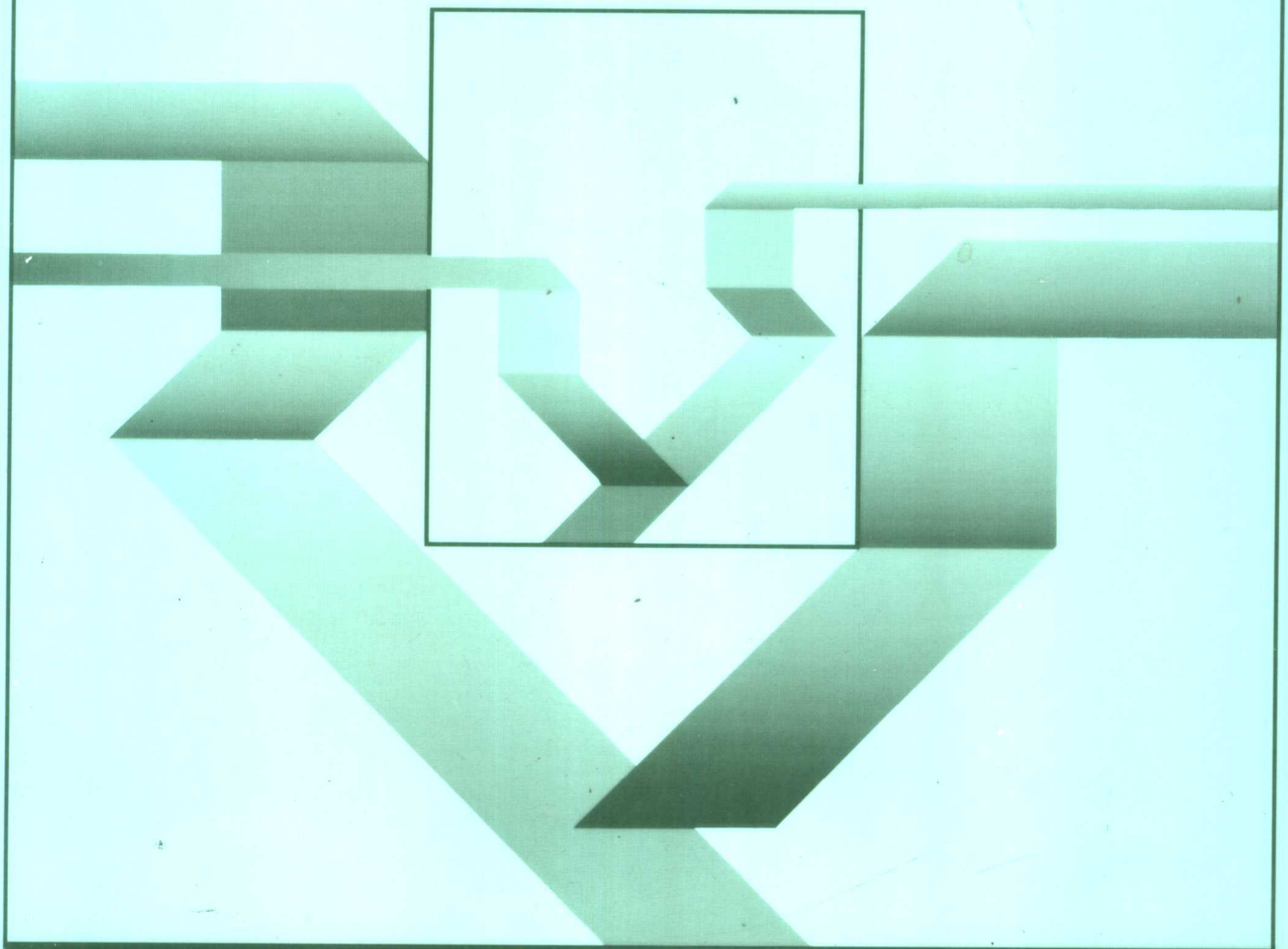
STUDY GUIDE
FOR USE WITH

Jack L. Smith • Robert M. Keith • William L. Stephens

ACCOUNTING PRINCIPLES

FOURTH EDITION



Joe D. Icerman   Paul F. Williams

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TO THE STUDENT

This *Study Guide* is designed to help you understand and master the principles of accounting. It is designed to be used with *Accounting Principles*, fourth edition, by Smith, Keith, and Stephens. For each chapter (and appendix) in the textbook, the *Study Guide* contains (1) a list of learning objectives; (2) a detailed chapter (or appendix) outline organized by learning objectives; (3) a comprehensive set of self-test questions; (4) exercises, some of which cover ethical issues and enhance critical thinking and communication skills; (5) solutions to the questions and exercises (located at the back of the *Study Guide*).

The study of accounting is difficult and especially time-consuming. It is important that you understand that accounting cannot be mastered by memorizing a few rules prior to each exam. The best way to learn accounting is to practice, practice, practice. Therefore, you need to develop an organized study system to be successful.

It is helpful to design your study system around frequent, relatively short study periods. You will learn much more if you study accounting regularly. All-night sessions are an inefficient use of your study time and can only lead to frustration. Study accounting every day and you will make excellent progress.

Every person must develop his or her own study system. As a starting point, a proven approach is summarized below. Consider this approach and modify it to fit your needs and circumstances.

1. Study the chapter in the textbook first. Use the learning objectives at the beginning of each chapter to get a preview of what is important in the chapter and what you are expected to learn from the chapter. Read the entire chapter to get an overall familiarity with the material covered in the chapter. After the initial reading, go back and study specific sections and examples in detail. Make sure you understand the examples and the key terms used in the chapter. A glossary of key terms is included at the end of each chapter in the textbook.

2. Review the learning objectives in the *Study Guide* to see how you are progressing. Study the chapter outline in the *Study Guide.* This outline summarizes the major topics in the chapter. If you have a good understanding of the chapter material, you should recognize the outline as a concise review of the chapter. Key terms appear in the *Study Guide* in boldface. If you do not understand a particular part of the chapter outline, refer back to the textbook for a more detailed discussion of the topic. Using the outline in this manner will give you an initial warning of any weak areas where more study is needed.

3. Complete the self-test questions and exercises in the *Study Guide.* Check your answers with those provided at the back of the *Study Guide.* You performance is another indication of your mastery of the material. If necessary, refer to the chapter outline or the textbook again to increase your understanding of troublesome topics.

4. Complete the textbook exercises and problems assigned by your instructor. As preparation for an exam, attempt to work at least some of the assigned problems without referring to the textbook, the *Study Guide*, or your class notes. It is better to develop your ability to work problems unaided at this point, rather than waiting until exam time.

Accounting is a cumulative discipline built on basic concepts and interrelationships. It is important to learn these basic concepts and to relate what you are currently studying to what you have learned previously. Study notes incorporated in the chapter outlines are designed to help you in this process.

Master the material in each chapter as you go along. Do not fall behind and expect to catch up right before the next exam. If you keep up, studying for the exam will not be a traumatic experience. The chapter outlines in the *Study Guide* provide an excellent review for exams.

When it is time to get ready for a class meeting and there are more interesting things to do than study accounting, keep the following thought in mind: the student who fails to prepare is preparing to fail. Do not let it happen to you!

Good luck in your studies and we hope the *Study Guide* is a valuable resource for you!

Joe. D. Icerman
Paul F. Williams

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INTRODUCTION The Accounting Environment

LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

1. Identify the users and preparers of accounting information.
2. List the various types of accounting activities.
3. Describe how the CPA provides credibility to the financial statements.
4. Distinguish the three types of business entities.
5. Explain the meaning of the term *generally accepted accounting principles.*
6. Identify the institutions that influence the development of accounting principles.
7. Define the key terms appearing in bold letters.

DETAILED CHAPTER OUTLINE AND STUDY GUIDE

Learning Objective 1:
Identify the users and preparers of accounting information.

A. **Accounting** is a service that provides many different users with financial information that will aid them in making economic decisions. The principles of gathering and presenting accounting information are similar for all economic entities.

B. **Economic entities** include all organizations that provide products and services to consumers. They can be divided into two types.

   1. Entities, such as major corporations, that are formed to make a profit, referred to as **business entities.** *Note:* We will be focusing on business entities in this text.

   2. Entities, such as hospitals and universities, that are not concerned with making a profit, referred to as **not-for-profit entities.**

C. Users of accounting information related to business entities include three groups.

   1. The *management group* includes the board of directors and managers of the entity.

   2. The *financing group* includes investors and potential investors, and creditors and potential creditors.

   3. The *public group* includes regulatory agencies, taxing authorities, employees, labor unions, and many others.

D. Business entities prepare two types of financial reports.

1. **External financial reports** are provided for users outside the entity who do not have access to the business entity's records. These reports are referred to as **general-purpose financial statements**. The accounting activities related to the preparation of external financial reports are called **financial accounting**.

2. **Internal financial reports** are prepared for users inside the entity, that is, the management of the business entity. The accounting activities related to the preparation of internal financial reports are called **management accounting**.

E. Preparers of accounting information include the management of the business entity and certified public accountants.

1. The management prepares and is responsible for the financial information. The **controller** is the person in charge of the accounting function of a business entity.

2. **Certified public accountants (CPAs)** are independent professional accountants who provide services to business entities and individuals for a fee. The CPA serves as a link between the management, who prepares the financial statements, and the users of the financial statements. CPAs assure the users that the financial statements of the business entity are presented fairly. The CPA provides this assurance by performing an **independent audit**, a check of the firm's financial records, and by issuing a formal report on the fairness of the financial statements.

Learning Objective 2:
List the various types of accounting activities.

F. Accounting activities and careers can be divided into two categories.

1. Individuals in *private accounting* are employed by a single entity and complete accounting activities related only to that business entity.

2. Individuals in *public accounting* offer their professional services to customers (business entities and individuals) for a fee.

G. Private accounting careers in business include the following activities:

1. **General financial accounting** involves recording business transactions and summarizing their results in financial reports.

2. **Accounting systems design** involves the development of forms and procedures for processing the large amount of accounting data.

3. **Cost accounting** is concerned with planning for and controlling costs. It also involves determining the costs of products manufactured and/or services rendered by the entity.

4. **Budgeting** helps plan future activities by setting goals and performance standards for future operations.

5. **Tax accounting** involves the preparation of reports required by federal, state, and local taxing authorities. It also includes analyzing the impact of taxes on planned future activities.

6. **Internal auditing** involves a review of the other accounting activities, the information they generate, and the procedures they follow to ensure that they are operating properly.

7. **Data processing** involves the actual manipulation of the large amounts of accounting data.

8. **International accounting** specialists are familiar with the laws, tax requirements, and accounting procedures of various countries.

9. Accountants in *education* pursue teaching, research, and consulting activities.

Learning Objective 3:
Describe how the CPA provides credibility to the financial statements.

H. Public accounting careers involve the following activities:

1. *Auditing* involves an independent check of a business entity's external financial reports (general-purpose financial statements) and the expression of an opinion by the CPA as to the fairness of the reports. An independent audit is performed to provide outside users of the financial reports an assurance that the financial reports of the business entity have been prepared fairly and properly. An independent audit is a check of the accounting records of the business entity by a CPA who is not employed by the entity and is independent of the entity. The CPA's opinion as to the fairness of the financial statements is included in the audit report, which is an integral part of the financial statements.

2. *Tax services* are provided to aid the client in the preparation of tax returns and in tax planning related to future activities.

3. *Management advisory services* are offered to help management improve the entity's performance.

Learning Objective 4:
Distinguish the three types of business entities.

I. There are three forms of business entities.

1. A **proprietorship** is an entity owned by a single person, the *proprietor.*

2. A **partnership** is an entity owned by two or more persons, called *partners.*

   a. Legally, proprietors and partners are not considered to be separate from the business entity. That is, proprietors and partners are personally responsible for all actions committed by the business entity.

   b. In accounting, the actions of the business entity are kept separate from the proprietor's and partner's personal affairs. The business entity is considered to be a separate *accounting entity.*

3. A **corporation** is an entity that is a separate legal entity chartered by a state. A corporation may have a few or many owners, referred to as *stockholders* or *shareholders.* Owners of a corporation can be held responsible only for the amount of money they have invested in the corporation. A corporation is both a separate legal entity and a separate accounting entity.

Learning Objective 5:
Explain the meaning of the term generally accepted accounting principles.

J. To make financial statements of different companies comparable, basic rules for presenting financial information have been developed. These rules are called **generally accepted accounting principles (GAAP).**

Learning Objective 6:
Identify the institutions that influence the development of accounting principles.

K. Several organizations have been influential in developing generally accepted accounting principles. These include:

1. The **Financial Accounting Standards Board (FASB).** The FASB is an independent organization established by the accounting profession that generally is responsible for developing GAAP.

2. The **Securities and Exchange Commission (SEC).** The SEC is a federal government agency that oversees the various laws regulating the distribution and sale of shares of stock in publicly held business entities. The SEC has the authority to require whatever accounting principles it desires. Up to this point, it usually has delegated this authority to the private sector (i.e., the FASB).

3. The **American Institute of Certified Public Accountants (AICPA)**. The AICPA is the national organization of CPAs established to represent their interests. Prior to the formation of the FASB, the AICPA was directly involved in developing GAAP through one of its committees, the *Accounting Principles Board (APB)*. The APB was eliminated when the FASB was formed.
4. The **American Accounting Association (AAA)**. The AAA is the national organization of accounting professors and educators.
5. The **Institute of Management Accountants (IMA)**. The IMA is a national organization of private accountants concerned with managerial accounting issues. The IMA sponsors an examination which results in individuals' being accredited as **certified management accountants (CMAs)**.

COMPLETION

Complete each statement below with the appropriate word or phrase.

1. Independent professional accountants who are licensed by a state to practice public accounting are called ____________________.
2. External financial reports that are prepared for users outside the business entity are called ____________.
3. The three forms of business entities are __________, ____________________, and ____________________.
4. The ______________________________ is the private-sector organization primarily responsible for developing generally accepted accounting principles.
5. ______________________________ is the accounting activity that involves planning for the future by setting goals and performance standards.
6. A business entity owned by one person is called a ______________________________.

TRUE OR FALSE

For each statement below, circle (T) if the statement is true or (F) if the statement is false.

T F 1. Accounting is a service that provides many different users with financial information that is helpful in making economic decisions.

T F 2. Certified public accountants are responsible for the financial information reported by a business entity.

T F 3. A partnership is a separate legal entity from its owners.

T F 4. An independent audit is performed by a CPA who is employed by the business entity being audited.

T F 5. The accounting activities related to preparing internal financial reports are called financial accounting.

T F 6. Internal auditing is the accounting activity concerned with the development of forms and procedures for processing large amounts of accounting data.

T F 7. The management group is primarily responsible for providing the money to operate a business entity.

T F 8. Internal financial reports are prepared for the management of a business entity.

T F 9. Tax compliance involves the study of the tax effects of various possible business transactions.

T F 10. The AICPA has a formal code of conduct to provide ethical guidance to its members.

MULTIPLE CHOICE

For each question, circle the letter corresponding to the best answer.

1. The person in charge of the accounting functions of a business entity is called:
a. A certified public accountant.
b. A controller.
c. An internal auditor.
d. An international accountant.

2. The accounting activity most concerned with planning and controlling costs is:
a. Data processing.
b. Taxation.
c. Accounting systems design.
d. Cost accounting.

3. The accounting activity most concerned with the recording of business transactions and the preparation of financial reports is:
a. Internal auditing.
b. Budgeting.
c. Data processing.
d. General financial accounting.

4. Certified public accountants engage in three major activities. These are:
a. Auditing, budgeting, and taxation.
b. Internal auditing, taxation, and data processing.
c. Auditing, taxation, and management advisory services.
d. Auditing, financial accounting, and management advisory services.

5. The federal government agency that is most concerned with generally accepted accounting principles is:
a. The Securities and Exchange Commission.
b. The Financial Accounting Standards Board.
c. The Internal Revenue Service.
d. The American Accounting Association.

6. The area of accounting concerned with preparing internal financial reports is:
a. Financial accounting.
b. Management accounting.
c. Tax accounting.
d. Internal auditing.

7. Expressing the objectives of a business entity in monetary terms is called:
a. Financial accounting.
b. Cost accounting.
c. Budgeting.
d. Internal auditing.

8. Owners of which of the following types of business entities are called stockholders?
a. Corporations.
b. Partnerships.
c. Proprietorships.
d. All the above.

9. Financial reports are used by:
a. Management.
b. Investors.
c. Creditors.
d. All the above.

10. The organization primarily responsible for the development of generally accepted accounting principles is the:
a. AICPA.
b. IMA.
c. AAA.
d. FASB.

EXERCISE 1: Critical Thinking/Communication Skills

Preparers of general-purpose financial statements must understand generally accepted accounting principles so that the statements will be prepared properly. Explain why it is also important for users of general-purpose financial statements to understand generally accepted accounting principles.

CHAPTER 1 Basic Concepts and the Accounting Model

LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

1. Identify and explain the basic purpose of the principal financial statements and the type of information contained in each.
2. List the basic accounting concepts and principles and explain what they are.
3. State and explain the basic accounting model.
4. Describe how business transactions affect the basic accounting model.
5. Record business transactions on a financial transaction worksheet.
6. Explain how the basic financial statements relate to each other and prepare these statements.
7. Define the key terms appearing in bold letters.

DETAILED CHAPTER OUTLINE AND STUDY GUIDE

Learning Objective 1:
Identify and explain the basic purpose of the principal financial statements and the type of information contained in each.

A. The principal financial statements of a business entity are the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows.

   1. The **income statement** provides information about the profitability of the business entity. It compares revenues earned with expenses incurred during a specified period of time to determine if the entity made a profit.

      a. A **revenue** is an inflow to the entity of cash or some other asset in exchange for goods sold or services rendered by the entity.

      b. **Expenses** represent the cost of economic resources consumed in providing products or services to customers. Expenses include the cost of goods sold by the entity and the cost of services used by the entity to generate revenue.

      c. The income statement may be prepared using the accrual basis of accounting or the cash basis of accounting.

         (1) The **accrual basis of accounting** considers revenue to be earned when services are performed, not when payment is received. Similarly, expenses are considered incurred when services are received, not when cash is paid.

(2) The **cash basis of accounting** records revenues and expenses only when cash is received or paid.

(3) Generally accepted accounting principles require the accrual method.

d. When revenues exceed expenses, the difference is **profit,** also called **net income.** When expenses exceed revenues, the difference is called a **net loss.**

2. The **statement of owner's equity** shows how the owner's investment in the business entity has changed during the period. Owner's equity is increased by net income and additional investments by the owner. It is decreased by a net loss and personal withdrawals by the owner. **Withdrawals** are assets removed from the business by the owner.

3. The **balance sheet** shows the business entity's financial position. It lists at a specific point in time the assets owned by the entity, the liabilities owed by the entity to others, and the owner's equity in the entity.

   a. **Assets** are economic resources owned by the entity that are expected to provide a future benefit to the entity. Assets may be physical items, such as cash, supplies, or equipment. Assets also may be nonphysical items, such as amounts due from customers that have not yet been collected (called **accounts receivable**). Assets are shown on the left side of the balance sheet.

   b. **Liabilities** are the debts of the entity owed to others. Liabilities include both formal promises to repay a borrowed amount of money (called a **note payable**) and informal promises to pay amounts such as the amount due to a creditor for goods received but not yet paid for (called **accounts payable**). Liabilities are shown on the right side of the balance sheet.

   c. The **owner's equity,** or **capital,** represents the owner's interest in the entity, that is, assets minus liabilities. The owner's equity is shown on the right side of the balance sheet, below the liabilities.

4. *Note:* It is important to remember that the income statement and the statement of owner's equity cover a period of time, while the balance sheet is a listing as of a specific point in time.

5. The **statement of cash flows** shows information about the cash receipts and cash payments of the business entity during a specified period of time. This statement is discussed in detail in Chapter 18.

Learning Objective 2:
List the basic accounting concepts and principles and explain what they are.

B. Five generally accepted accounting principles and concepts are discussed in this chapter. They are summarized below.

1. The **cost principle.** Assets are recorded at the amount paid for them. The amount recorded, referred to as the *historical cost,* does not change until the asset (or some part of it) is disposed of.

2. The **objectivity principle.** Amounts recorded must be based on verifiable, objective evidence.

3. The **business entity concept.** For accounting purposes, each business entity should be considered separate from its owners.

4. The **going concern concept.** For accounting purposes, it is assumed that each business entity will be in existence indefinitely.

5. The **stable dollar concept.** For accounting purposes, it is assumed that the purchasing power (value) of a dollar is constant over time.

Learning Objective 3:
State and explain the basic accounting model.

C. The **basic accounting model** is the foundation of the financial statements. It is expressed in the form of the balance sheet equation:

Assets = Liabilities + Owner's Equity

This equality is always true. The left side of the equation represents the resources owned by the entity and the right side represents the claims to those resources.

Learning Objective 4:
Describe how business transactions affect the basic accounting model.

D. As the entity completes **financial transactions** (exchanges of goods or services) with other entities, the components of the balance sheet equation change; but the equality is always maintained. Each transaction has two parts; for example, an asset is increased and a liability is increased, or one asset is increased and another asset is decreased. Since each transaction has two parts, the term **double-entry accounting** is used to refer to the recording of financial transactions.

Learning Objective 5:
Record business transactions on a financial transaction worksheet.

E. The changes related to each specific asset, liability, and owner's equity item are accumulated under a separate heading called an **account,** which eases the recording process. For example, all changes in the amount of cash on hand are recorded under the asset account Cash.

F. Each transaction will affect two (or more) accounts. For example:

1. Collecting \$100 due from a customer for goods sold previously increases Cash by \$100 and decreases Accounts Receivable by \$100.
2. Borrowing \$500 from a bank by signing a note increases Cash by \$500 and increases Notes Payable by \$500.
3. Purchasing \$70 of supplies **on account** (promising to pay later) increases Supplies on Hand by \$70 and increases Accounts Payable by \$70.
4. Paying for the supplies purchased in item (3) decreases Cash by \$70 and decreases Accounts Payable by \$70.

G. You must be able to analyze the effects of financial transactions on the balance sheet equation in order to be successful in the study of accounting. Review pages 35 through 41 in the text and make sure that you thoroughly understand the examples given there.

Learning Objective 6:
Explain how the basic financial statements relate to each other and prepare these statements.

H. Preparing the financial statements:

1. Prepare the income statement first because you need net income for the statement of owner's equity. The income statement in equation form is:

   Revenues − Expenses = Net Income

2. Prepare the statement of owner's equity next because you need total owner's equity for the balance sheet. The statement of owner's equity in equation form is:

   Beginning Owner's Equity + Investments + Net Income
   − Withdrawals = Ending Owner's Equity

3. Prepare the balance sheet last. Remember, the balance sheet equation is:

   Assets = Liabilities + Owner's Equity

COMPLETION

Complete each statement below with the appropriate word or phrase.

1. The ____________________ provides information regarding the financial position of a business entity.
2. For accounting purposes, the assumption that a business entity will be in existence long enough to complete projects it undertakes is called the ____________________ ____________________ concept.
3. When expenses are greater than revenues for a period of time, the business has a ____________________ ____________________ for the period.
4. The basic accounting model is ____________________ equal ____________________ plus ____________________.
5. Net income is equal to ____________________ minus ____________________.

TRUE OR FALSE

For each statement below, circle (T) if the statement is true or (F) if the statement is false.

T F 1. The cash basis of accounting is required by generally accepted accounting principles.

T F 2. The income statement relates to a period of time.

T F 3. Resources consumed in the process of generating revenues are called expenses.

T F 4. Additional investments made by the owner of a business entity should be added to the beginning owner's equity in the statement of owner's equity.

T F 5. The financial statements of a proprietorship should not include the owner's personal assets and liabilities.

T F 6. Financial statements adjust for the changing value of a dollar over time.

T F 7. Liabilities represent the owner's interest in the assets of a business entity.

T F 8. The cost principle states that assets should be recorded at their historical cost.

T F 9. Total assets minus total liabilities is equal to the owner's equity in the business entity.

T F 10. The balance sheet lists the assets, liabilities, and owner's equity of a business entity for a period of time.

T F 11. A business that has more expenses than revenues during a period has earned a profit.

T F 12. A written promise to repay an amount of money borrowed is called an account payable.

T F 13. The statement of cash flows provides information about the cash receipts and cash payments of a business entity for a period of time.

T F 14. When an account payable is paid with cash, the owner's equity in the business decreases.

T F 15. When an account receivable is collected in cash, the total assets of the business entity increase.

MULTIPLE CHOICE

For each question, circle the letter corresponding to the best answer.

1. Revenues can be defined as:
a. Economic resources owned by the entity that are expected to provide future benefits.
b. Inflows of assets in exchange for goods sold or services rendered by the entity.
c. Any increase in owner's equity.
d. An increase in cash.

2. The objectivity principle requires that:
a. Business transactions be consistent with the objectives of the entity.
b. Accounting principles meet the objectives of the Securities and Exchange Commission.
c. Amounts recorded in the financial statements be based on independently verifiable evidence.
d. The Financial Accounting Standards Board be fair and unbiased in its deliberations over new accounting standards.

3. The Kirby Company estimated that because of inflation and other factors the value of its land had increased from $6,000 to $10,000. Therefore, the company wrote up the Land account from $6,000 to $10,000. Which of the following accounting principles were violated?
a. Cost principle.
b. Objectivity principle.
c. Going concern principle.
d. Both (a) and (b).
e. All the above.

4. For accounting purposes, the business entity should be considered separate from its owners if the entity is a:
a. Corporation.
b. Partnership.
c. Proprietorship.
d. Both (b) and (c).
e. All the above.

5. An owner invests $600 cash in the business. Which of the following is true?
a. An asset is increased and a liability is increased.
b. An asset is increased and owner's equity is decreased.
c. An asset is decreased and owner's equity is increased.
d. An asset is increased and owner's equity is increased.

6. A liability in the amount of $500 is paid in cash. Which of the following is true?
a. An asset is increased and a liability is decreased.
b. An asset is increased and a liability is increased.
c. An asset is decreased and a liability is decreased.
d. A liability is decreased and owner's equity is increased.

7. An owner withdraws $300 cash from the business. Which of the following is true?
a. An asset is decreased and owner's equity is decreased.
b. An asset is decreased and owner's equity is increased.
c. An asset is increased and a liability is decreased.
d. There is no effect on any asset, liability, or owner's equity.

8. An expense is incurred that will be paid for next month. Which of the following is true?
a. An asset is decreased and owner's equity is decreased.
b. An asset is increased and a liability is increased.
c. A liability is increased and owner's equity is increased.
d. A liability is increased and owner's equity is decreased.

9. A customer is billed for services rendered. Which of the following is true?
a. An asset is increased and a liability is decreased.
b. An asset is increased and owner's equity is increased.
c. One asset is increased and another asset is decreased.
d. There is no effect on any asset, liability, or owner's equity.

10. The amount due from a customer who was billed last month is collected. Which of the following is true?
a. An asset is decreased and owner's equity is decreased.
b. An asset is increased and owner's equity is increased.
c. One asset is increased and another asset is decreased.
d. An asset is increased and a liability is increased.

11. Which one of the four major financial statements relates to a specific point in time?
a. Statement of cash flows.
b. Income statement.
c. Statement of owner's equity.
d. Balance sheet.

12. Which of the following items would be included in the statement of owner's equity?
a. Net income for the period.
b. The amount of owner withdrawals from the business during the period.
c. The amount invested in the business by the owner during the period.
d. All the above.
e. Only (b) and (c).

13. Office equipment is purchased by signing a note payable for the cost of the equipment. Which of the following is true?
a. An asset is increased and a liability is increased.
b. One asset is increased and another asset is decreased.
c. An asset is increased and owner's equity is increased.
d. An asset is increased and owner's equity is decreased.

14. The owner's capital account had a balance of $12,900 at the beginning of the period. During the period, the business suffered a net loss of $1,400 and the owner invested an additional $4,600 in the business. What is the amount of owner's equity at the end of the period?
a. $6,900.
b. $12,900.
c. $16,100.
d. $18,900.
e. None of the above.

15. During the current year the Peabody Tanning Salon had revenues of $92,000 and expenses of $65,000, and Ms. Peabody withdrew $24,000 from the business for her personal use. For the current year the business had a:
a. Net income of $27,000.
b. Net income of $3,000.
c. Net loss of $3,000.
d. Net loss of $27,000.