Study Guide

Volume I, Chapters 1-12

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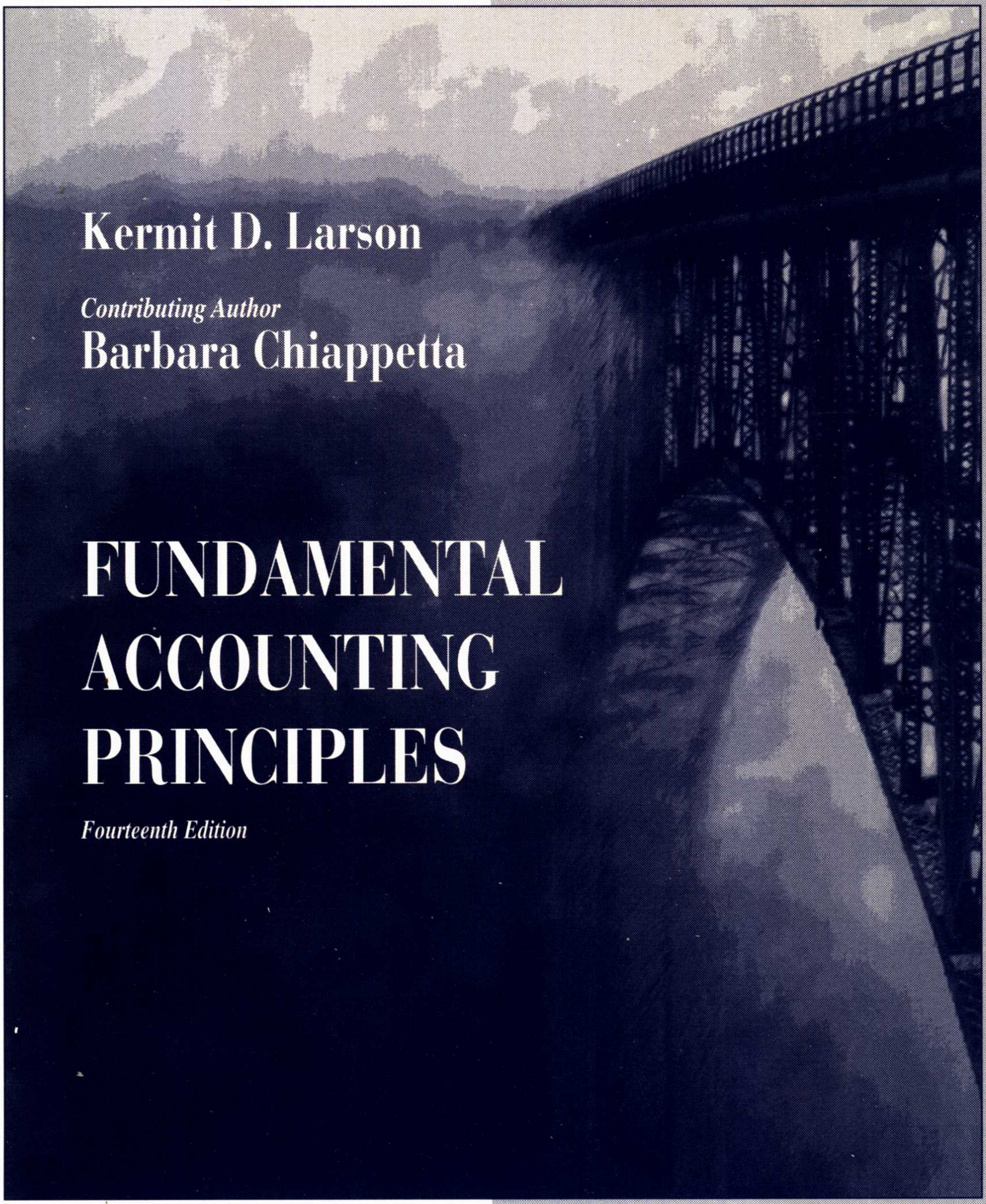

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FUNDAMENTAL ACCOUNTING PRINCIPLES

Fourteenth Edition

STUDY GUIDE

Volume I, Chapters 1-12

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FUNDAMENTAL ACCOUNTING PRINCIPLES

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To the Student

This booklet is designed to help you review the material covered in *Fundamental Accounting Principles*. You should understand that the booklet is not intended to substitute for your review of *Fundamental Accounting Principles*. Instead, the objectives of this booklet are as follows:

1. To remind you of important information that is explained in the text. For example, the topical outline of each chapter reminds you of important topics in the chapter. In reading the outline, you should ask yourself whether or not you understand sufficiently the listed topics. If not, you should return to the appropriate chapter in *Fundamental Accounting Principles* and read carefully the portions that explain the topics about which you are unclear.
2. To provide you with a quick means of testing your knowledge of the chapter. If you are unable to correctly answer the problems that follow the chapter outline, you should again return to the appropriate chapter in *Fundamental Accounting Principles* and review the sections about which you are unclear.

Your best approach to the use of this booklet is as follows:

First, read the learning objectives and the related summary paragraphs. Then, ask whether your understanding of the chapter seems adequate for you to accomplish the objectives.

Second, review the topical outline, taking time to think through (describing to yourself) the explanations that would be required to expand the outline. Return to *Fundamental Accounting Principles* to cover areas of weakness.

Third, answer the requirements of the problems that follow the topical outline. Then, check your answers against the solutions that are provided after the problems.

Fourth, return to *Fundamental Accounting Principles* for further study of the portions of the chapter about which you made errors.

Table of Contents

Prologue

Your Introduction to Business, Accounting, and Ethics

Learning Objective 1:

Describe the main purpose of accounting and its role in organizations.

Summary

The main purpose of accounting is to provide useful information to people who make rational investment, credit, and similar decisions. These decision makers include present and potential investors, lenders, and other users. The other users include managers of organizations, suppliers who sell to them, and customers who buy from them. Internally, accounting provides information that managers use in the following areas of activity: finance, human resources, research and development, production, marketing, and executive management.

Learning Objective 2:

Describe the external role of accounting for organizations.

Summary

In addition to using accounting information to meet internal needs, organizations also report accounting information to various external parties. These external decision makers include people who invest in the organizations and people who loan money to them. Lenders need information to assess whether the company has enough financial strength and profitability to pay its debts.

Learning Objective 3:

List the main fields of accounting and the activities carried on in each field.

Summary

Accountants work in private, public, and government accounting. All three have members who work in financial, managerial, and tax accounting. Financial accountants prepare or audit financial statements that are distributed to people who are not involved in day-to-day management. Managerial accountants provide information to people who are involved in day-to-day management. Managerial accounting activities include general accounting, cost accounting, budgeting, internal auditing, and management advisory services. Tax accounting includes preparing tax returns and tax planning.

Learning Objective 4:

State several reasons for the importance of ethics in accounting.

Summary

Ethics are principles that determine the rightness or wrongness of particular acts or activities. Ethics are also principles of conduct that govern an individual or a profession. The foundation for trust in business activities is the expectation that people are trustworthy. Ethics are especially important for accounting because users of the information have to trust that it has not been manipulated. Without ethics, accounting information could not be trusted, and economic activity would be much more difficult to accomplish.

Learning Objective 5:

Define or explain the words and phrases listed in the Prologue glossary.

Summary

See Problem I.

Topical Outline

I. The main purpose of accounting and its internal and external roles

   A. The main purpose of accounting is to provide useful financial information to decision makers so they can make better decisions. Because of this, accounting is often described as a "service activity."

   B. The internal role of accounting is to serve all of the other departments in the organization by providing them with useful information that helps them complete their tasks.

      1. Finance departments need cash flow information to project future cash flows.

      2. Human resources departments need information about employees and payroll costs.

      3. Research and development departments need cost reports so they can make decisions about continuing projects.

      4. Production departments need information about operating costs, and must follow internal control procedures provided by the accounting department.

      5. Marketing departments need information about sales and marketing costs.

      6. Executive managers depend on financial statements, budgets, and performance reports to make major decisions for the organization, develop long-term strategies, motivate employees, and deal with the public or the owners.

   C. The external role of accounting is to provide useful information to decision makers outside of the organization, such as potential investors and lenders, owners who are not managers, suppliers and customers, and government agencies that regulate business activities or collect taxes.

II. Recording and analyzing accounting information

   A. The difference between accounting and bookkeeping

      1. Bookkeeping is the clerical part of accounting that records transactions and other events.

      2. Accounting includes identifying how transactions and events should be described in financial statements, and designing and implementing systems to control the operations of an organization, all of which require more professional expertise and judgment than bookkeeping.

   B. Accounting and computers

      1. Computers are widely used in accounting because they can quickly and efficiently store, process, and summarize large quantities of financial data.

      2. However, there is still a need for people who can design accounting systems, supervise their operation, analyze complex transactions, and interpret reports.

III. The types and fields of accounting

   A. The three types of accountants

      1. Private accountants work for a single employer, usually a business.

      2. Public accountants offer their services to the public, and therefore work for many different clients. They may be self-employed or work for a public accounting firm.

      3. Government accountants are employed by local, state, and federal government agencies.

B. The three fields of accounting

1. Financial accounting

    a. Private financial accountants prepare financial statements.

    b. Public financial accountants audit financial statements.

    c. Government financial accountants prepare financial statements, review financial reports, write regulations, assist businesses, and investigate violations.

2. Managerial accounting

    a. Private managerial accountants perform activities such as general accounting (which includes financial accounting), cost accounting, budgeting, and internal auditing.

    b. Public managerial accountants provide management advisory services.

    c. Government managerial accountants, like private managerial accountants, perform general accounting, cost accounting, budgeting, and internal auditing functions.

3. Tax accounting

    a. Private tax accountants prepare tax returns and assist in tax planning.

    b. Public tax accountants also prepare tax returns and assist in tax planning.

    c. Government tax accountants review tax returns, assist taxpayers, write regulations, and investigate violations.

IV. Ethics in accounting

A. Decision makers must be able to trust that the information in financial statements and other accounting reports has not been manipulated, and that the accountant is protecting their interests. When trust is lacking, our commercial and personal lives are much more complicated, inefficient, and unpleasant.

B. Ethics codes for accountants have been adopted and enforced by professional organizations, including the American Institute of Public Accountants (AICPA) and the Institute of Management Accountants (IMA).

Problem I

Many of the important ideas and concepts discussed in the prologue are reflected in the following list of key terms. Test your understanding of these terms by matching the appropriate definitions with the terms. Record the number identifying the most appropriate definition in the blank space next to each term.

________	Accounting	________	General accounting
________	AICPA	________	Generally accepted accounting principles
________	Audit	________	Government accountants
________	Bookkeeping	________	Internal auditing
________	Budgeting	________	IRS
________	CIA	________	Management advisory services
________	CMA	________	NASBA
________	Controller	________	Private accountant
________	Cost accounting	________	Public accountants
________	CPA	________	SEC
________	Ethics	________	Tax accounting
________	GAAP		

1. American Institute of Certified Public Accountants; the largest and most influential national professional organization of Certified Public Accountants in the United States.
2. A service activity that provides useful information to people who make rational investment, credit, and similar decisions to help them make better decisions.
3. The field of accounting that includes preparing tax returns and planning future transactions to minimize the amount of tax; involves private, public, and government accountants.
4. An activity that adds credibility to reports produced and used within an organization; internal auditors not only examine record-keeping processes but also assess whether managers are following established operating procedures.
5. The process of developing formal plans for future activities, which then serve as a basis for evaluating actual performance.
6. A managerial accounting activity designed to help managers identify, measure, and control operating costs.
7. The chief accounting officer of an organization.
8. Rules adopted by the accounting profession as guides for measuring and reporting the financial condition and activities of a business.
9. A thorough check of an organization's accounting systems and records that adds credibility to financial statements; the specific goal is to determine whether the statements reflect the company's financial position and operating results in agreement with generally accepted accounting principles.
10. The public accounting activity in which suggestions are offered for improving a company's procedures; the suggestions may concern new accounting and internal control systems, new computer systems, budgeting, and employee benefit plans.
11. Securities and Exchange Commission; the federal agency created by Congress in 1934 to regulate securities markets, including the flow of information from companies to the public.
12. The part of accounting that records transactions and other events, either manually or with computers.

13. Certified Public Accountant; an accountant who has passed an examination and has met education and experience requirements; licensed by a state board to practice public accounting.

14. The task of recording transactions, processing the recorded data, and preparing reports for managers; also includes preparing the financial statements that executive management presents to external users.

15. The abbreviation for generally accepted accounting principles.

16. Certified Internal Auditor; a certification that an individual is professionally competent in internal auditing; granted by the Institute of Internal Auditors.

17. Internal Revenue Service; the federal agency that has the duty of collecting federal taxes and otherwise enforcing tax laws.

18. National Association of State Boards of Accountancy.

19. Certificate in Management Accounting; a certification that an individual is professionally competent in managerial accounting; awarded by the Institute of Management Accountants.

20. Accountants employed by local, state, and federal government agencies.

21. Accountants who provide their services to many different clients.

22. An accountant who works for a single employer, which is often a business.

23. Principles that determine the rightness or wrongness of particular acts or activities; also accepted standards of good behavior in a profession or trade.

Solutions for Prologue

Problem I

Accounting	2
AICPA	1
Audit	9
Bookkeeping	12
Budgeting	5
CIA	16
CMA	19
Controller	7
Cost accounting	6
CPA	13
Ethics	23
GAAP	15 or 8
General accounting	14
Generally accepted accounting principles	8
Government accountants	20
Internal auditing	4
IRS	17
Management advisory services	10
NASBA	18
Private accountant	22
Public accountants	21
SEC	11
Tax accounting	3

1 Financial Statements and Accounting Principles

Learning Objective 1:

Describe the information presented in financial statements, be able to prepare simple financial statements, and analyze a company's performance with the return on equity ratio.

Summary

The income statement shows a company's revenues, expenses, and net income or loss. The balance sheet lists a company's assets, liabilities, and owner's equity. The statement of changes in owner's equity shows the effects on owner's equity from investments by the owner, withdrawals, and net income or net loss. The statement of cash flows shows the changes that resulted from operating, investing, and financing activities. The financial statements are prepared with information about the effects of each transaction on the accounting equation. The company's performance can be analyzed by comparing the company's return on equity with rates on other investments available to the owner.

Learning Objective 2:

Explain the accounting principles introduced in the chapter and describe the process by which generally accepted accounting principles are established.

Summary

Accounting principles help accountants produce relevant and reliable information. Among others, broad accounting principles include the business entity principle, the objectivity principle, the cost principle, the going-concern principle, and the revenue recognition principle. Specific accounting principles for financial accounting are established in the United States primarily by the Financial Accounting Standards Board (FASB), with oversight by the Securities and Exchange Commission (SEC). Auditing standards are established by the Auditing Standards Board (ASB), a committee of the American Institute of CPAs (AICPA). The International Accounting Standards Committee (IASC) identifies preferred practices and encourages their adoption throughout the world.

Learning Objective 3:

Describe single proprietorships, partnerships, and corporations, including any differences in the owners' responsibilities for the debts of the organizations.

Summary

A single (or sole) proprietorship is an unincorporated business owned by one individual. A partnership differs from a single proprietorship in that it has more than one owner. Proprietors and partners are personally responsible for the debts of their businesses. A corporation is a separate legal entity. As such, its owners are not personally responsible for its debts.

Learning Objective 4:

Analyze business transactions to determine their effects on the accounting equation.

Summary

The accounting equation states that Assets = Liabilities + Owner's Equity. Business transactions always have at least two effects on the elements in the accounting equation. The accounting equation is always in balance when business transactions are properly recorded.

Learning Objective 5:

Define or explain the words and phrases listed in the chapter glossary.

Summary

See Problem III.

Topical Outline

I. Financial statements

A. The income statement indicates whether a business earned a profit by showing:

1. Revenues—inflows of assets received in exchange for goods or services provided to customers as part of the major or central operations of the business.

2. Expenses—outflows or the using up of assets as a result of the major or central operations of a business.

3. Net income (excess of revenues over expenses) or net loss (excess of expenses over revenues) for a period.

B. The balance sheet provides information about a company's financial status as of a specific date by showing:

1. Assets—properties or economic resources owned by the business; probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

2. Liabilities—debts owed by a business or organization; probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

3. Equity—the difference between a company's assets and its liabilities; the residual interest in the assets of an entity that remains after deducting its liabilities; also called net assets.

C. The statement of changes in owner's equity shows the beginning and ending balances of owner's equity for a period, and the items that caused the net change, including:

1. Increases due to investments by the owner or net income.

2. Decreases due to withdrawals by the owner or a net loss.

D. The statement of cash flows describes where a company's cash came from and where it went during a period. The cash flows are classified as being caused by operating, investing, and financing activities.

II. Generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS)

A. GAAP include both broad and specific principles. The broad principles discussed in this book are:

1. Business entity principle—every business is to be accounted for separately and distinctly from its owner or owners.

2. Objectivity principle—financial statement information is to be supported by evidence other than someone's opinion or imagination.

3. Cost principle—financial statements are to present information based on costs incurred in business transactions; assets and services are to be recorded initially at the cash or cash-equivalent amount given in exchange.

4. Going-concern principle—financial statements are to reflect the assumption that the business will continue operating instead of being closed or sold, unless evidence shows that it will not continue.

5. Revenue recognition principle—revenue should be recognized at the time it is earned; the inflow of assets associated with revenue may be in a form other than cash; and the amount of revenue should be measured as the cash plus the cash equivalent value of any noncash assets received from customers in exchange for goods or services.

6. The time period, matching, materiality, full-disclosure, consistency, and conservatism principles are discussed in later chapters.

B. Organizations involved in developing GAAP and GAAS

1. The Financial Accounting Standards Board (FASB) is the primary authoritative source for establishing new accounting principles, which are published in its Statements of Financial Accounting Standards (SFAS).

2. Other professional organizations support the FASB's process with input and financial support, including the American Accounting Association (AAA), Financial Executives Institute (FEI), Institute of Management Accountants (IMA), Association for Investment Management and Research (AIMR), and the Securities Industry Association (SIA).

3. Prior to FASB, the accounting profession depended on the Accounting Principles Board (APB), from 1959 to 1973, and the Committee on Accounting Procedure (CAP), from 1936 to 1959, to identify GAAP.

4. The Auditing Standards Board (ASB) is a special committee of the AICPA and is the authority for identifying GAAS. The SEC is an important source of the ASB's authority.

C. In an effort to increase harmony among the accounting practices of different countries, accounting organizations from around the world have created the International Accounting Standards Committee (IASC) to identify preferred accounting practices and encourage their worldwide acceptance.

III. Legal forms of business organizations

A. Single proprietorship—an unincorporated business owned by one individual; the owner is personally responsible for the debts of the business.

B. Partnership—an unincorporated business that is owned by two or more people; the partners are personally responsible for the debts of the business.

C. Corporation—a business established as a separate legal entity under state or federal laws; the owners (stockholders) are not responsible for the debts of the business.

D. Differences in the financial statements

1. On the balance sheet, proprietorships and partnerships list the names of the owners and their capital balances in the owner's equity section. The capital balances are the accumulation of owner investments and withdrawals as well as net incomes and losses. A corporation's equity section is called stockholders' equity, and is made up of contributed capital (owner investments from sales of stock) and retained earnings (the accumulation of net incomes and losses, reduced by dividends to the stockholders).

2. Because a corporation is a separate legal entity, salaries paid to managers are reported as expenses on the income statement. However, if the owners of proprietorships or partnerships perform managerial services in the operations of the business, there is no expense reported on the income statement for their services. (If owners withdraw cash from the business, their capital accounts are reduced.)

IV. The accounting equation and recording transactions

A. The accounting equation (or balance sheet equation) is a way of describing the relationship between a company's assets, liabilities, and equity. It is expressed as: Assets = Liabilities + Owner's Equity.

B. When business transactions are properly recorded, they always have at least two effects on the accounting equation, and the equation always remains in balance.

V. Return on equity ratio

A. One way to judge a business's relative success is to compare its return on equity ratio to the ratios of other activities or investments.

B. The return on equity ratio is: net income for a period divided by beginning owner's equity.

C. For proprietorships and partnerships, the formula can be modified to reflect the managerial services of the owners or partners by deducting the fair value of their efforts from net income.