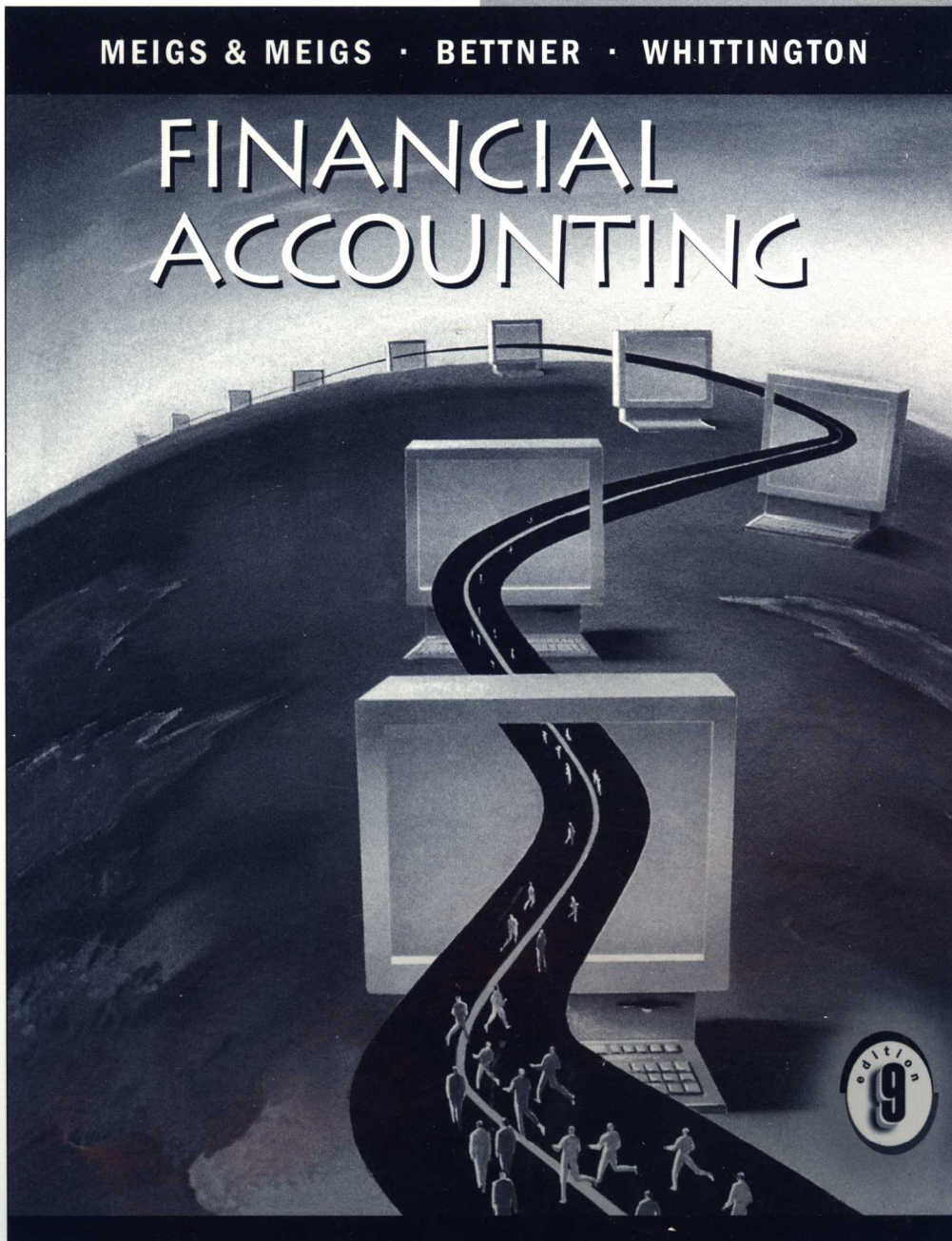


Study Guide

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FINANCIAL ACCOUNTING



Study Guide
for use with
**Financial
Accounting**

Ninth Edition

Robert F. Meigs

Mary A. Meigs

Mark Bettner

Ray Whittington



Boston, Massachusetts Burr Ridge, Illinois Dubuque, Iowa
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FINANCIAL ACCOUNTING

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TO THE STUDENT

This self-study guide is designed for your use as a student taking your first course in accounting at either the undergraduate or the graduate level. It is prepared to accompany *Financial Accounting, ninth edition*. The key purposes of this study guide are:

1. To help you in *mastering the material* as you initially study each chapter.
2. To *summarize the essential points* in each chapter and to *test your knowledge* with a series of objective questions and exercises, thus making it possible for you to *review the material quickly* from time to time, particularly before examinations.
3. To make the study of accounting *more enjoyable and more efficient* for you. This is accomplished by presenting an informal and concise summary of each chapter, followed by three groups of objective questions and some short exercises. The answers to these questions and exercises are provided at the end of each chapter *in order to give you immediate feedback and to point out areas that need additional attention*.

The manner in which each student uses this guide may differ. However, we recommend the following approach:

1. Study the chapter in your textbook.
2. Read the *Highlights of the Chapter* section of the study guide. If you encounter any statements that you do not understand, refer to the textbook for a more detailed discussion of the topic.
3. Work the questions and exercises in the *Test Yourself* section of the study guide, and compare your answers and solutions with those provided at the end of the chapter. This will show you how well you really understand the material contained in the related chapter of your textbook. Again, if you find something you do not understand, refer to your text for a thorough discussion of the subject.
4. Work the problems assigned as homework in your text.

Once you have mastered the material in this manner, rereading the *Highlights of the Chapter* section of the study guide will assist you in quickly reviewing the material before examinations.

Robert F. Meigs
Mary A. Meigs
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1

ACCOUNTING: THE LANGUAGE OF BUSINESS

HIGHLIGHTS OF THE CHAPTER

1. Accounting is the means by which we *measure* and *describe* the results of economic activities. The basic purpose of accounting is to provide financial information about a business enterprise or any other economic entity. This information is needed internally by managers and also by outsiders such as bankers, creditors, investors, and certain government agencies. In short, anyone who must make *decisions* regarding an economic activity (or about a business enterprise) has need of *accounting information*.
2. To really understand "accounting," you must understand three things:
 - a. The nature of the economic activities described in the accounting report.
 - b. The assumptions and measurement techniques involved in developing the information.
 - c. What information is most relevant to the decision at hand.Throughout this course, you should make a concerted effort to consider every accounting measurement from each of these three perspectives.
3. For example, let us apply this "three-perspectives" approach to the discussion in Chapter 1 of the presentation of assets in a balance sheet. What should you understand about "assets"? First, know what they represent—*future economic benefits* that have been purchased by the business. Next, know that current accounting practice is to value most assets at *cost*. Thus, a balance sheet provides information about the *nature* and *dollar amount* (cost) of *financial resources* owned. This information is useful in evaluating the company's ability to pay its debts, and also in determining whether its resources are being used efficiently.
4. If you look at accounting information from each of these perspectives, you should find it both interesting and meaningful. And you will acquire analytical skills that you will use throughout your career. If you concentrate only on learning technical accounting rules and procedures, you will miss much of what this course has to offer.
5. The major types of accounting reports include (a) financial statements, (b) tax returns, (c) specialized reports to management, and (d) reports to governmental regulatory agencies. In this accounting course, we shall emphasize the information contained in financial statements.
6. The process of providing financial information about a business to decision makers other than management and employees is termed *financial reporting*. These "outsiders" may include investors, creditors, financial analysts, government regulators and in some cases, even the general public (including the company's competitors).
7. *Financial statements* are the primary means of reporting financial information about a business to persons outside of the organization. A complete "set" of financial statements for a corporation includes:
 - a. A *balance sheet* showing the financial position of the company at a given date.
 - b. An *income statement* indicating profitability of the business over a specific time period.
 - c. A *statement of retained earnings* explaining changes in the amount of owners' equity in the business over a specific time period.
 - d. A *statement of cash flows* summarizing cash receipts and cash payments over the same period covered by the income statement.A complete set of financial statements also includes several pages of *notes* useful in interpreting the statements.

These statements are prepared by the company's accounting department; management is primarily responsible for the statements' reliability.
8. Publicly owned companies are *required by law* to provide financial statements to all owners, and also to make these statements available to the public.

Smaller businesses are not legally required to provide financial information to the public, but they often provide such information to owners, creditors, and management.

An income tax return is not a financial statement, but it is based upon many of the same accounting concepts.

For these reasons, the accounting concepts used in financial statements have become widely used throughout the business community. In fact, they often are called **generally accepted accounting principles** (GAAP).

9. An audit is an **investigation** of the annual financial statements performed by independent certified public accountants (CPAs). This investigation provides outsiders with reasonable assurance that the financial statements provide a fair and complete picture of the company's financial position and operations.
10. Auditors do not guarantee the accuracy of financial statements, but they do express an expert **opinion** on the statements' "fairness." Over the years, audited financial statements have developed an impressive track record of reliability. The financial statements of all publicly owned companies are audited every year.
11. Accounting information about publicly owned companies is readily available to the public. These companies issue **annual reports**, which include several years' audited financial statements and other information about the company's operations. In addition, financial analysts often make analyses and forecasts relating to these companies. A company's income tax returns, however, are **not** "public information."
12. Every company maintains an accounting system to meet its needs for accounting information. These needs may include financial statements, tax returns and other reports, and information used in daily business operations.
13. Regardless of whether an accounting system is operated manually or makes use of a computer, the system performs three basic functions. First, the company's economic activities are **recorded** in accounting records. Next, the recorded data are **classified** to accumulate subtotals for various types of activities. Finally, the classified data are **summarized** in accounting reports designed to meet the needs of decision makers.
14. The **transactions approach** to recording economic activities focuses upon completed transactions, that is, events that (1) cause an **immediate change** in the financial position of the business, and (2) can be **measured objectively** in monetary terms. The primary strength of this approach is that the information is reliable and can be measured objectively. A weakness is that some nonfinancial events may not be recorded.
15. If a business is to operate efficiently, the information in its accounting system **must** be reliable. All of the steps taken to ensure the reliability of a company's accounting data, to safeguard its assets, and to ensure compliance with management's policies form the company's **internal control structure**. The study of internal control and of accounting are closely related.
16. The accounting concepts, measurement techniques, and standards of presentation used in the financial statements of publicly owned companies are called **generally accepted accounting principles (GAAP)**. In addition to **comparability** (among different companies) and **reliability**, six other generally accepted accounting principles are introduced in this chapter: the **business entity concept**, the **cost principle**, the **going-concern assumption**, the **objectivity principle**, the **stable-dollar assumption**, and the **concept of adequate disclosure**.
17. In the United States, five groups which have been influential in improving accounting principles and practices are the **American Institute of Certified Public Accountants (AICPA)**, the **Securities and Exchange Commission (SEC)**, the **American Accounting Association (AAA)**, the **Institute of Management Accountants (IMA)**, and the **Financial Accounting Standards Board (FASB)**. The FASB conducts research and issues Statements of Financial Accounting Standards which represent authoritative expressions of generally accepted accounting principles.
18. The three most common forms of business entities are sole proprietorships, partnerships, and corporations. Accounting principles and concepts apply to all three forms of organization.
A sole proprietorship is a business owned by one individual.
A partnership is a business owned by two or more people who have agreed to act as partners.

A corporation is a business granted a charter by the state and owned by **stockholders**.

19. Ownership of a corporation is evidenced by **shares of capital stock** which may be sold by one investor to another. The stockholders elect a **board of directors** to oversee the operation of the business; the directors, in turn, appoint officers and managers of the business.
20. A corporation is legally an entity separate from its owners. Thus, the stockholders' liability for the losses incurred by an unsuccessful corporation is limited to the amount they have invested in the business. Nearly all large businesses and many small ones are organized as corporations.
21. The three most widely used financial statements are the **balance sheet**, the **income statement**, and the **statement of cash flows**. A balance sheet shows the financial position of a business at a particular date. It consists of a list of the company's assets, liabilities, and owners' equity. (The income statement will be discussed in Chapter 3; the statement of cash flows in Chapter 4.)
22. Accounting information is gathered for specific business entities. A business **entity** is any economic unit which enters into business transactions. The business entity is regarded as separate from its owners; the entity owns its own property and has its own debts. In preparing a balance sheet, the **same** definition of the "business entity" must be used in identifying the assets, liabilities, and owners' equity of the business.
23. Assets are economic resources owned by a business, such as land, buildings, and cash. Assets are valued on a balance sheet at their **cost**, rather than at current market prices, because cost is more factual and can be more **objectively determined** than current market value. Another reason for valuing assets at cost is that a business is assumed to be a **going concern** that will keep and use such assets as land and buildings rather than sell them.
24. Adhering to the cost basis of accounting implies that the dollar is a **stable** unit of measurement, as is a gallon, or an inch. The cost principle works well in periods of stable prices. Severe inflation, however, weakens the usefulness of cost as a basis for asset valuation. In recent years, the FASB has required large corporations to experiment with disclosures of "price-level adjusted" accounting data. However, the cost of developing this information was found to exceed the benefits. Thus, at present, the **cost principle** and the **stable dollar assumption** remain generally accepted accounting principles in this country.
25. Liabilities are debts. Either borrowing money or buying on credit will create a liability. Liabilities represent the claims of **creditors** to the resources of the business. Examples of liabilities are accounts payable and notes payable.
26. Owners' equity represents the owners' investment in the business; it is equal to total assets minus liabilities. Owners' equity in a corporation is called **stockholders' equity**. The equity of the owners is a residual amount. It is the claim to all resources (assets) of the business **after** the claims of the creditors have been satisfied. If a loss occurs, it is the owners' equity rather than the creditors' claims which must absorb the loss. Thus, creditors view the owners' equity as a "buffer" which protects the safety of their claims to the resources of the business.
27. Increases in stockholders' equity result from (a) the owners investing cash or other assets in the business in exchange for capital stock and (b) profitable operation of the business. Stockholders' equity is decreased by (a) the payment of **dividends** to stockholders and (b) unprofitable operation of the business.
28. In the balance sheet of a corporation, stockholders' equity is presented in two parts: capital stock and retained earnings. **Capital stock** represents the owners' equity resulting from the owners investing assets in the business. **Retained earnings** represents the increase in owners' equity resulting from profitable operation of the business. The term retained earnings describes only those earnings which were **not** paid out as dividends to stockholders.
29. Ownership in a corporation is evidenced by transferable **shares of capital stock**, and owners are called **stockholders**. The caption **Capital Stock** in the balance sheet of a corporation represents the amount invested in the business by its owners when the shares of stock were issued. The transfer or sale of shares of stock from one stockholder to another has **no effect** upon the corporation's assets, liabilities or amount shown in the Capital Stock account. The corporation simply revises its list of stockholders to reflect the number of shares held by each owner after the transfer.
30. The "accounting equation" is **Assets = Liabilities + Owners' Equity**. The listing of assets shows us what things the business owns; the listing of liabilities and owners' equity tells us who supplied these resources to the business and how much each group supplied.

31. The first step in any business venture should be the development of a **business plan**. A business plan summarizes management's goals and strategies for achieving these goals, often including financial projections. Companies are not required to prepare business plans, and business plans are **not** public information; however, they serve many useful purposes.
- Management must focus on goals, business strategies, capital requirements, and profit potential in preparing the business plan. The plan may aid in raising capital from creditors and investors, especially in the first years. Business plans assist in evaluation of the company's progress toward goals.
32. You should become familiar with the effects of various transactions upon a balance sheet.
- Purchasing an asset for cash is merely trading one kind of asset for another. Total assets will not change.
 - Purchasing an asset on credit will cause total assets to increase because additional resources are being acquired, and none is being given up. However, total liabilities will increase by the same amount.
 - Paying a liability with cash will cause both total assets and total liabilities to decrease.
33. Financial statements are used by outsiders in making investment decisions, hence financial statements are designed to provide information useful to these decision makers. Two factors of concern to outsiders are the **solvency** and **profitability** of the business organization. Being solvent means having the liquid resources to pay debts on time. One key indicator of short-term solvency is to compare a company's liquid resources with the liabilities requiring payment in the near future. Profitable operations (discussed further in Chapter 3) increase the value of the owners' equity in the business.
34. The concept of **adequate disclosure** means that all significant facts necessary for the proper **interpretation** of the financial statements are provided to the users of the financial statements. Adequate disclosure can take place in the body of the financial statements, or in **notes** accompanying the statements.
35. In the United States, investors and creditors generally regard financial statements to be **fair and reliable** due to the following four factors: companies' systems of **internal control**, the concept of **adequate disclosure**, **audits** performed by independent CPAs, and **federal securities laws**.
36. Professional judgment enters into many aspects of the field of accounting. To ensure public confidence in the judgment of professional accountants, accountants must demonstrate that they possess the characteristics of **competence** and **integrity**. Professional competence is evaluated by the accounting professional and state governments through use of examinations (such as the **Uniform CPA Examination**), and imposition of "continuing education" requirements. Integrity is just as important as competence, but it is more difficult to measure and enforce. Many accounting organizations have developed **codes of professional ethics** for their members.
- * 37. Careers in accounting may be divided into four broad areas: (a) the public accounting profession, (b) managerial accounting, (c) governmental accounting, and (d) accounting education.
- * 38. **Public accounting** is practiced by **certified public accountants**, called CPAs. CPAs are granted a license to practice by the state, and perform professional accounting services for clients for a fee. These services include:
- Auditing** An audit is an investigation of a company's accounting system by an independent CPA firm. This study enables the CPA firm to express its **professional opinion** as to the fairness and reliability of the company's financial statements.
 - Tax services** Taxes often play an important role in financial decisions. CPA firms offer "tax planning" services to minimize the impact of taxes on their clients and also assist in the preparation of their clients' income tax returns.
 - Management advisory services** CPA firms may become familiar with their clients' problems and be able to recommend corrective action. This service is actually **management consulting**.
- * 39. **Managerial accounting** refers to the work done within an organization by the members of its accounting department. Managerial accountants develop accounting information to meet the many needs of

* Supplemental Topic B, "Careers in Accounting."

management. There are many specialties within this field, including financial reporting, systems design, forecasting (or budgeting), cost accounting, income taxes, and internal auditing.

- * 40. **Internal auditors** are company employees who evaluate all aspects of the internal control structure. Their basic goal is to determine that the entire business is operating efficiently. Thus, internal auditors may be called upon to investigate and evaluate any aspect of the company's operations. However, they do not perform the independent audits of the company's financial statements. As company employees, they are not viewed as "independent" of management.
- * 41. Managerial accountants are not required to be licensed as CPAs. However, a number of them earn a **Certificate of Management Accounting (CMA)** or a **Certificate of Internal Auditing (CIA)** as evidence of their professional competence.
- * 42. **Governmental accounting** includes many specialized areas such as monitoring regulated industries, auditing tax returns, and preparing budgets for governmental agencies. Three important governmental agencies using accounting information are:
 - a. The **General Accounting Office (GAO)** audits many of the agencies within the federal government, and reports to Congress.
 - b. **Internal Revenue Service** The IRS processes the federal income tax returns filed by individuals and corporations.
 - c. **Securities and Exchange Commission** The SEC reviews and approves the financial disclosure by corporations that offer their securities for sale to the public.
- * 43. **Accounting education** The many rewarding careers available to accounting graduates have led to a shortage of accounting faculty at colleges and universities. Individuals qualified to become accounting faculty members can find positions available in virtually all parts of the country. A career as a faculty member allows an individual great freedom to pursue his or her specific professional interests.

TEST YOURSELF ON THIS INTRODUCTORY CHAPTER

True or False

For each of the following statements, circle the T or the F to indicate whether the statement is true or false.

- T F 1. The basic purpose of accounting is to provide financial information to economic decision makers.
- T F 2. Financial statements are confidential documents made available only to the top management of a business enterprise
- T F 3. The most useful financial statement would be a detailed list of every business transaction in which the business enterprise has been involved.
- T F 4. By using the transaction approach one will be assured that all important events which happen in the firm are reflected in the financial statements of the company.
- T F 5. One important element of an audit performed by a CPA firm is that users of the financial statements are guaranteed against any losses they may incur by investing in that company.
- T F 6. Bookkeeping is only a small part of the field of accounting and probably the simplest part.
- T F 7. A comprehensive list of all generally accepted accounting principles (GAAP) is available for accountants and users of financial statements.
- T F 8. The Financial Accounting Standards Board (FASB) is an authoritative source of generally accepted accounting principles in the United States.
- T F 9. One characteristic of a corporation is that its owners are personally liable for any losses incurred by the business.
- T F 10. Assets are valued on the balance sheet at current liquidation values to show how much cash would be realized if the business went broke.
- T F 11. The cost principle of asset valuation is no longer widely used in the U.S.

* Supplemental Topic B, "Careers in Accounting."

- T F 12. Losses from unprofitable operations cause the owners' equity in a business enterprise to decrease.
- T F 13. The purchase of a building for cash will cause total assets to increase.
- T F 14. The payment of a liability will not affect total assets, but will cause total liabilities to decrease.
- T F 15. In the balance sheet of a sole proprietorship, any increase in capital earned through profitable operations and retained in the business is added to the capital originally invested, and a single figure is shown for the owners' capital.
- T F 16. Corporations are required to show capital stock and retained earnings separately in the balance sheet.
- T F 17. A business that is unable to pay its debts is said to be *insolvent*.
- T F 18. A business can become insolvent even though it is operating profitably.
- T F 19. The chief accounting officer of a corporation is usually called the controller.
- T F 20. A forecast for a business enterprise is always prepared by the CPA firm conducting the annual audit.

Completion Statements

Fill in the necessary words or amounts to complete the following statements:

- A complete set of financial statements for a corporation includes:
(a) _____, (b) an _____,
(c) a _____ and (d) a _____.
- The three basic steps in the accounting process are (a) _____ transactions, (b) _____ these events into groups, and (c) _____ the information in accounting reports.
- The accounting concepts, measurement techniques, and standards of presentation used in the preparation of financial statements are called _____.
- An investigation of the accounting system of a business to determine the fairness of the firm's financial statements is called an _____.
- The governmental agency which reviews and approves the financial disclosure by companies which offer their securities to the public is the _____.
- Statements of Financial Accounting Standards** are authoritative expressions of generally accepted accounting principles issued by the _____.
- Two primary objectives of most business concerns are (a) making a _____ and (b) remaining _____.
- The steps taken to ensure the reliability of the accounting information and to safeguard the assets of the firm against waste, fraud, or inefficient use make up the _____ structure.
- The three common forms of business organizations are (a) _____, (b) _____, and (c) _____.
- The heading of a balance sheet should include (a) _____, (b) _____, and (c) _____.
- Since the claims of _____ have priority over those of the _____ of a business, the owners' equity is called a _____ claim.
- The accounting equation states that _____ = _____ + _____.

* Supplemental Topic B, "Careers in Accounting."

13. Land advertised for sale at \$90,000 was purchased for \$80,000 cash by a development company. For property tax purposes, the property was assessed by the county at \$25,000. The development firm intended to sell the property in parcels for a total of \$150,000. The land would appear on the balance sheet of the development company among the _____ at a value of \$_____.
14. On December 15, Shadow Mountain Golf Course had a contractor install a \$90,000 sprinkler system. Since no payment to the contractor was required until the following month, the transaction was not recorded in December and was not reflected in any way in the December 31 balance sheet. Indicate for each of the following elements of the balance sheet whether the amounts were overstated, understated, or correct. Total assets, _____, total liabilities, _____, owners equity _____.
15. The owners' equity in a business comes from two sources: (a) _____ by owners and (b) _____ operations.
16. A transaction which causes total liabilities to increase but which has no effect on owners' equity must cause total assets to _____.
17. Retained earnings represent the total earnings (profits) of a business which have not been paid out as _____ to the _____.
18. The concept of _____ requires providing with financial statements any financial facts necessary for proper interpretation of those financial statements.

Multiple Choice

Choose the best answer for each of the following questions and enter the identifying letter in the space provided.

- _____ 1. The field of **accounting** may best be described as:
 - a. Preparation of income tax returns for individuals and businesses.
 - b. Recording of transactions in accounting records.
 - c. Art of interpreting, measuring, and describing economic activity.
 - d. Issuance of an independent opinion as to the fairness of a company's financial statements.
- _____ 2. The principal function of **CPAs** is:
 - a. Performing audits to lend assurance to people outside a business entity that the financial statements prepared by the company's management are reliable and complete.
 - b. Providing managers with the accounting information needed for the daily operation of the business, as well as for long-range planning.
 - c. Evaluating the system of internal control to ensure that accounting reports are reliable and that company policies are followed in all areas of business operations.
 - d. Performing audits of income tax returns to determine that taxpayers are paying their fair share of income taxes.
- _____ 3. The accounting staff of a large company such as IBM might perform all of the following tasks except:
 - a. Evaluate the system of internal control throughout the business.
 - b. Prepare financial statements.
 - c. Issue an independent auditors' report upon the fairness of the company's financial statements.
 - d. Develop financial forecasts.
- _____ 4. The principal reason for the annual audit of a business corporation by a firm of certified public accountants (CPAs) is:
 - a. To obtain an independent expert opinion on the fairness and dependability of the financial statements prepared by the company and distributed to stockholders, bankers, and other outsiders.
 - b. To detect fraud on the part of company personnel.
 - c. To assist the accounting department of the company in handling the heavy year-end work of preparing financial statements.
 - d. To relieve management of the responsibility for financial reporting to stockholders and other outsiders.

- _____ 5. **Generally accepted accounting principles**
- Are the rules followed in preparing income tax returns.
 - Are the "ground rules" followed in preparing financial statements.
 - Apply to corporations, but not to businesses organized as sole proprietorships or partnerships.
 - Assure management that the entire business operates according to plan.
- _____ 6. The **Financial Accounting Standards Board (FASB)**:
- Issues authoritative expressions of generally accepted accounting principles.
 - Performs independent audits of the financial statements of large companies.
 - Audits the income tax returns and accounting records of both individuals and corporations.
 - Reviews the annual financial statements of all corporations which offer securities for sale to the public.
- _____ 7. A strong internal control structure provides assurance that:
- The entire business operates according to management's plan.
 - The business will have sufficient cash to pay its debts as they come due.
 - The business will stay solvent.
 - The business will operate profitably.
- _____ 8. Which of the following best describes the nature of an **asset**?
- Something with a ready market value.
 - An economic resource, which will provide some future benefits, owned by a business.
 - Tangible property (something with physical form) owned by a business.
 - The amount of the owners' investment in a business.
- _____ 9. The **owners' equity** in a business may best be described as:
- An economic resource which is owned by a business and is expected to benefit future operations.
 - An obligation of the business entity.
 - Profits that have been retained in the business rather than being withdrawn by the owners.
 - Assets minus liabilities.
- _____ 10. The balance sheet item, **Retained Earnings**:
- Appears in the stockholders' equity section for a corporation in which earnings have exceeded dividends.
 - Is always equal to the amount of cash owned.
 - Appears on the balance sheet of a sole proprietorship if the earnings of the business have exceeded the withdrawals by the proprietor.
 - Appears among the assets of any form of business organization in which earnings have exceeded amounts distributed to owners.
- _____ 11. In this chapter, several accounting principles relating to the valuation of assets are discussed. Which of the following is **not** one of these principles?
- The cost principle—assets generally are recorded at cost rather than at estimated market values.
 - Objectivity—accountants prefer to use values that can be objectively verified.
 - Going-concern assumption—accountants assume that a business acquires assets such as land, buildings, and equipment for use and not for resale.
 - The safety principle—assets are recorded in the accounting records at the lower of cost or insured value.

- _____ 12. Which of the following equations *cannot* be derived from the basic accounting equation (Assets = Liabilities + Owners' Equity)?
- Assets - Liabilities = Owners' Equity.
 - Liabilities = Assets - Owners' Equity.
 - Owners' Equity = Liabilities - Assets.
 - Assets - Owners' Equity = Liabilities.
- _____ 13. A *business plan*
- Is one of the basic formal financial statements for a business.
 - Must be audited annually by a firm of independent certified public accounts.
 - Is not public information.
 - Must be filed along with the company's income tax return each year.
- _____ 14. Which of the following transactions causes *total assets to increase by \$10,000*?
- Purchasing an automobile for \$10,000 cash.
 - Purchasing \$10,000 of office furniture on account.
 - Collecting a \$10,000 account receivable.
 - Paying a \$10,000 liability.
- _____ 15. Magic Forest Land Development Company sold a parcel of land at a profit. This will cause:
- A decrease in assets and liabilities.
 - An increase in assets and owners' equity.
 - An increase in assets and liabilities.
 - A decrease in liabilities and owners' equity.
- _____ 16. Lake Arrowhead Boat Shop bought a \$700 electric hoist to lift engines out of boats. The boat shop paid \$200 in cash for the hoist and signed a note to pay the balance in 60 days. This transaction will cause:
- The boat shop's assets to increase by \$700 and liabilities to increase by \$500.
 - Assets to increase by \$500 and owners' equity to decrease.
 - No change in total assets, but a \$500 increase in liabilities and a similar decrease in owners' equity.
 - No change in owner's equity, but a \$500 increase in both assets and liabilities.
- _____ 17. Reliability of financial statements is strengthened by:
- Audits performed by independent CPAs.
 - The concept of adequate disclosure.
 - The competence and integrity of the accountants involved in preparation of the financial statements.
 - All of the above.

Exercises

1. Listed below are eight technical accounting terms emphasized in this chapter.

<i>GAAP</i>	<i>Capital Stock</i>
<i>CPAs</i>	<i>Owners' equity</i>
<i>FASB</i>	<i>Accounting equation</i>
<i>Solvent</i>	<i>Business entity</i>

Each of the following statements may (or may not) describe one of these technical terms. In the space provided below each statement, indicate the accounting term described, or answer "None" if the statement does not correctly describe any of the terms.

- An economic unit which enters into business transactions.

- Assets minus liabilities.

- c. The organization that issues authoritative statements as to proper methods for reporting information in financial statements.
- d. Professional accountants who provide accounting and auditing services to clients.
- e. Able to pay debts as they come due.
- f. That portion of stockholders' equity resulting from retaining profits in the business, rather than distributing them as dividends to the stockholders.
- g. The accounting standards and concepts used in the preparation of financial statements.

2. In the space provided below, prepare a balance sheet for the Titan Corporation at December 31, 19____, from the following alphabetical list of accounts:

Accounts payable.....	\$ 28,000
Accounts receivable.....	37,000
Automobiles.....	8,000
Buildings.....	60,000
Capital stock	100,000
Cash	14,000
Income taxes payable.....	12,000
Land.....	35,000
Office equipment	16,000
Retained earnings.....	30,000

TITAN CORPORATION
Balance Sheet
December 31, 19__

Assets		Liabilities & Stockholders' Equity	
	\$	Liabilities:	\$
	\$		\$

3. Use the following information to complete the balance sheet of the Unitrex Corporation on December 31, 19__.
- The corporation was organized on January 1, 19__, and has operated for the full year 19__.
 - Earnings have amounted to \$100,000, and dividends of \$20,000 have been paid to stockholders.
 - Cash and Accounts Receivable together amount to three times as much as Accounts Payable.

UNITREX CORPORATION
Balance Sheet
December 31, 19__

Assets		Liabilities & Stockholders' Equity	
Cash	\$ 42,000	Liabilities:	
Accounts receivable		Notes payable	\$
Land	90,000	Accounts payable	
Building	260,000	Income taxes payable	40,000
Office equipment	<u>56,000</u>	Total liabilities	<u>\$112,000</u>
		Stockholders' equity:	
		Capital Stock	
		Retained earnings	
Total Assets	<u>\$.....</u>	Total liability and stockholder's equity	<u>\$592,000</u>

4. The Billiard Den was organized by Robert Neal on July 1 of the current year. In the space below, indicate the effect of each of the following transactions on the various balance sheet items of the Billiard Den. Indicate the new balance for every item after the July 3 transaction and each subsequent transaction. The effects of the July 1 transaction are already filled in to provide you with an example.

- July 1** Issued capital stock to Robert Neal in exchange for \$20,000 cash invested in the business.
- 3** Purchased an existing pool hall at a price of \$21,000 for the land and \$30,000 for the building. Billiard Den paid the former owner \$10,000 in cash and issued a short-term note payable for the balance of the purchase price.
- 10** Purchased 10 pool tables for \$1,000 each, paying \$6,000 cash and agreeing to pay the balance due in 30 days.
- 14** Sold one pool table to a friend for \$1,000. The friend paid \$500 cash to the Billiard Den and promised to pay the balance within 30 days.
- 20** Paid \$2,000 of the amount owed on the pool tables.
- 24** Collected \$200 from the friend who has bought the pool table.
- 30** Purchased one used pool table from another pool hall, paying \$600 cash.

	Assets					=	Liabilities		+	Owners' Equity
	Cash	Accounts Receivable	Land	Building	Pool Tables		Notes Payable	Accounts Payable		Capital Stock
July 1	+\$20,000									+\$20,000
3										
Balances										
10										
Balances										
14										
Balances										
20										
Balances										
24										
Balances										
30										
Balances										

SOLUTIONS TO CHAPTER 1 SELF-TEST

True or False

1. **T** Economic decision makers include the executives and managers of the business as well as outsiders such as business owners, bankers, creditors, potential investors, labor unions, the government, etc. Information about the financial position and operating results of a business is vital in making decisions about the future.
2. **F** Financial statements are the main source of financial information to persons outside the business organization; they are also of great importance to management.
3. **F** Financial statements *summarize* information contained in the hundreds or thousands of pages comprising the detailed accounting records of a business. A detailed list of *every* business transaction would be too cumbersome to be useful to decision makers.
4. **F** The transactions approach records only completed transactions that cause an immediate change in the financial position of the business, and which can be measured objectively in monetary terms. Consequently, many important events are not recorded in the accounting records because they do not meet this definition of a "transaction."
5. **F** Although an audit performed by independent CPAs enhances reliability of the financial statements, auditors do not guarantee the accuracy of the financial statements, nor do they indemnify investors against losses.
6. **T** *Bookkeeping* involves only the record-making phase of accounting and tends to be mechanical and repetitive. *Accounting* also includes the design of efficient accounting systems, performance of audits, development of forecasts, income tax work, and the interpretation of accounting information.
7. **F** Accounting is a constantly evolving body of knowledge, and there are many problems and conflicts for which definitive answers are yet to be developed.
8. **T** The FASB is one of four authoritative groups influential in the improvement of financial reporting and accounting practices in the United States. The others are the American Institute of CPAs, the Securities and Exchange Commission, and the American Accounting Association.
9. **F** A corporation is a legal entity *separate* from its owners, unlike a sole proprietorship or partnership. In a sole proprietorship or partnership, the owner(s) are personally liable for all debts incurred by the business.
10. **F** An asset is shown in a balance sheet at its historical cost—the dollar amount originally paid by the business to acquire the asset.
11. **F** As of the current time, the cost basis is still the generally accepted method of showing assets on the balance sheet in the United States.
12. **T** Also, distribution of cash or other assets by the business to the owners (such as payment of dividends) causes a decrease in owners' equity.
13. **F** There is no change in total assets; cash was decreased by the amount paid out, but a new asset, a building, was acquired.
14. **F** Payment of a liability causes a decrease in cash (asset) and an equal decrease in liabilities.
15. **T** A sole proprietorship is not required to maintain a distinction between invested capital and earned capital.
16. **T** The state laws which govern the incorporation of businesses require that the owners' equity of a corporation be separated into categories of *earned* capital (retained earnings) and *invested* capital (such as capital stock).
17. **T** To be solvent is to have cash on hand sufficient to pay debts as they fall due.
18. **T** Many of the assets of a profitable business may consist of real estate or machinery or accounts receivable from customers. If *cash* is not available to pay debts promptly, the business is insolvent.
- * 19. **T** The term *controller* recognized management's use of accounting data to "control" business operations.
- * 20. **F** Financial forecasts are prepared by accountants who are employed by the business; they are *private accountants*, not the public accountants performing the audits.

Completion Statements

1(a) Balance sheet, (b) income statement, (c) statement of retained earnings, (d) statement of cash flows. 2(a) Recording, (b) classifying, (c) summarizing. 3. Generally accepted accounting principles. 4. Audit. 5. Securities and Exchange Commission. 6. Financial Accounting Standards Board. 7(a) Profit, (b) solvent. 8. Internal control. 9(a) Sole proprietorships, (b) partnerships, (c) corporations. 10(a) Name of the company, (b) name of the statement, (c) date. 11. Creditors, owners, residual. 12. Assets, liabilities, owners' equity. 13. Assets, \$80,000. 14.

* Supplemental Topic B, "Careers in Accounting."