

Student Study Guide for use with

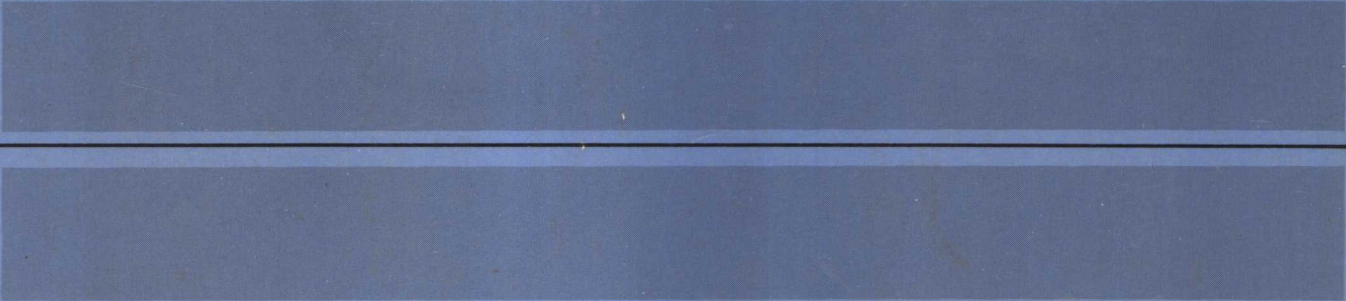
INTERMEDIATE ACCOUNTING

SEVENTH EDITION

Volume I

Chapters 1-13

WELSCH, NEWMAN AND ZLATKOVICH



Student Study Guide

for use with

Intermediate Accounting Seventh Edition

Volume I

Chapters 1-13

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*All of
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~~1986~~

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Homewood, Illinois

Preface

The two volumes of this **Student Study Guide** are designed to facilitate your study of Welsch, Newman, and Zlatkovich. **Intermediate Accounting**, 7th Edition, published by Richard D. Irwin, Inc. However, they can be helpful to you when used with other textbooks on the same subject.

The two volumes of the study guide are especially helpful because they provide the following separately for each chapter:

1. Study suggestions for the chapter.
2. A study outline of the chapter, including concise explanations and examples of the primary issues.
3. A series of examination-type questions and problems for self-evaluation. Answers are given in the back of this study guide.

Appreciation is expressed to the many individuals who provided valuable suggestions for this revision. Special thanks are due Jody Saari-Dachtler, May-Lin Melissa Gan, and Annick Michele Barton for excellent editorial assistance.

June 1986

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Study suggestions for the student

This Study Guide is designed to help you review the textbook, to self-evaluate your knowledge level of each chapter, and to provide guidance for further study.

Experience has convinced the authors that a **logical study plan consistently followed** will assure success in intermediate accounting. Experience also has demonstrated that this study guide will increase your knowledge level without undue expenditure of additional time. The review and self-evaluation features are designed to increase your competence in completing homework and examinations. Accounting is learned best by understanding the concepts, standards, and the reasons (rationale) of accounting, rather than by memorization. Accounting is similar to mathematics in some ways. That is, it is logical, provides fairly precise answers, and "problems" must be solved to have an effective learning process. Completion of the questions for self-evaluation (and the assigned homework) will contribute significantly to the learning process. The cumulative feature of accounting should be understood. That is, each chapter constitutes a building block for the chapters which follow. Thus, your success in the later chapters (and later accounting courses) is related directly to the level of comprehension attained earlier. If you do not master each link (chapter) in sequence your chances for later success are reduced significantly. If followed consistently, the study suggestions given below should significantly enhance your success in intermediate accounting.

Use of the textbook. When a chapter is started, you should read all of it carefully (or that portion assigned by your instructor). The word "carefully" is used advisedly because an accounting textbook **cannot** be read like most other books. The material discussed is cumulative and is characterized by some complexity. Prior to reading, the purpose of the chapter and the sequential **captions** should be noted because they focus on the central issues discussed. Examples and illustrations should be studied carefully. As a chapter is read, usually it is advisable to make marginal marks and notes (often questions) as a reminder that restudy is desirable (or to pose questions in class). Throughout your study of a chapter **focus on the logic of the explanations (the concepts) and the reasons why.**

After the first reading return to certain parts of the chapter for **in-depth study**. After sustained effort, if you do not understand the material, you should be prepared to ask clear and relevant questions in class to clear up specific items. Such questions should be cleared up before the next chapter is studied. Finally, **always be prepared before the class meeting.** If you are behind in studying the chapter, you are apt to gain very little from the class discussions. The farther one falls behind, the more difficult it is to catch up. The chapters should be studied regularly; cramming just before the examinations is apt to be ineffective, frustrating, and not time efficient.

Note-taking. We recommend that you take class notes on important items discussed (and reminders of items for restudy). This is a valuable aspect of the learning process and provides review of materials for items emphasized by your professor. In addition, your professor supplements the discussions in the textbook at most class meetings. The supplementation includes new ideas, new examples, extension of discussions in the text, and more significantly, interpretations and logical explanations of the subject matter. Professors naturally tend to emphasize on examinations those issues which they emphasize in the class discussions. Therefore your note taking is important.

Homework assignments. Homework is assigned by your professor to (a) provide a learning experience; (b) apply concepts, standards, and procedures; (c) learn to do by doing; and (d) test your knowledge level and proficiency. One cannot learn accounting only by reading descriptions of it, no matter how many times the description is read. As with mathematics, accounting can be learned only by both reading about it and actually **doing it.** This latter phase of the learning process involves solving the assigned exercises, problems, and cases.

We cannot overemphasize the importance of completing your homework assignments, that is, the implementation (doing) phase.

To solve the homework assignments efficiently, and with maximum benefit, we recommend the following steps in order:

- a. Read the **requirements** of the exercise, problem, or case carefully.
- b. Read the **problem** carefully and note all **relevant facts**. Except on short exercises, problems, and cases, note the relevant facts on a scratch pad or underscore them in your text.
- c. Relate the facts to the requirements and decide upon a **solution approach**.
- d. **Solve the exercise, problem, or case**. When necessary, refer to the chapter for assistance on specific points. Show computational steps where appropriate. (You may want to use the solution forms given in the separate book of forms).
- e. Review the completed solution. Be sure all of the requirements are satisfied.

When homework assignments are discussed later in class, take notes and make corrections on your solution. Such notes are valuable for review purposes in preparing for examinations.

Use of this study guide. We believe you can attain maximum benefits from this study guide if you consistently adhere to the following procedures:

- a. Before studying the chapter read the section in this study guide entitled "Study Suggestions for the Chapter."
- b. Complete your reading and study of the chapter.
- c. Complete the homework.
- d. Turn to the section in this guide for the particular chapter titled "Study Outline of the Chapter." Go over this outline carefully as a **review** of the chapter. Space is provided throughout the outline for **additional notes** that you may want to add for future review.
- e. Turn to the section of this guide for the particular chapter titled "Questions and Problems for Self-Evaluation." Answer each requirement to the best of your ability **without** referring to the chapter or to the answers provided herein.
- f. After answering all of the questions to the best of your ability, turn to the solutions in the back of this study guide and **grade yourself**.
- g. On the basis of your answers, as graded, decide what parts of the chapter you should study further. In respect to those questions on which you were largely unsuccessful, and after further study of the chapter, go back and try them again without further reference to the answers provided therein.

Preparing for examinations. Examinations are given by your professor to measure your mastery of the subject matter. Examinations often worry students unduly and may lead to tension. These undesirable conditions can be minimized by adequate study on a regular basis and a reasonable review of the major topics. Inadequate preparation causes a **lack of confidence** which is the real cause of tension.

The best preparation for examinations, is effective and consistent study of each chapter as it is assigned. The suggestions given above, relate to this endeavor. Because a large portion of most examinations in accounting courses involve quantitative problems (i.e., application) that must be solved within a limited amount of time, the ability to work under pressure is important. You can significantly increase your problem-solving (application) competence in accounting by:

- a. Working the assigned homework on your own and with some time pressure.
- b. Solving the questions for self study given in this guide while exerting some time pressure. Most of these questions are of the "examination type."
- c. Test yourself by reworking selected problems that you have already been exposed to, such as completed homework, the study guide questions, and examples given in the chapter (the solution is also there).
- d. Read **all of the exercises** given in the text and ascertain that you can solve each one.

Our experience also indicates that many students lose "points" because they do not (a) read the "**problems facts**" carefully (be sure you understand the facts; if not, ask your instructor for clarification) and (b) read the **requirements** carefully (be sure you understand the requirements; if not, ask for clarifications).

In taking an examination spend your time on the questions that have the higher weight. If you get "stuck" go on to the next problem. If items are omitted, place a large mark in the side margin so you won't forget to come back to them.

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The Environment and Conceptual Foundation of Accounting

Study Suggestions for the Chapter

This chapter presents an overview of financial accounting and summarizes the theoretical foundation which underlies all of *Intermediate Accounting*. Careful reading of it is suggested. Most of your attention should be devoted to **Part B, the conceptual foundation**, because it will be referred to throughout all of the succeeding chapters. This chapter is nonquantitative. It provides a broad overview. Your study should be sufficient to capture the primary aspects of each concept presented. This will require restudy of those concepts and principles.

Study Outline of the Chapter

Part A—Overview of Accounting

- A. Fundamentally, accounting serves two groups of decision-makers.
 - 1. **Internal** decision-makers—the management of the entity (called management accounting).
 - 2. **External** decision-makers—outside groups such as stockholders, potential investors, creditors, and the public at large (called financial accounting).

- B. Accounting information is communicated to external decision-makers by means of **general purpose financial statements** which include the:
 - 1. **Income statement**—revenues minus expenses equal net income (also called the statement of operations).
 - 2. **Balance sheet**—assets equal liabilities plus owners' equity (also called statement of financial position).
 - 3. **Statement of changes in financial position**—fund inflows minus fund outflows equal net change in funds (funds statement).
 - 4. **Supplementary disclosure notes** (including schedules).

- C. In recent years, two **Boards** and one **Federal regulatory agency** have served as the primary standards (or principles) setting entities; they are:
1. APB—Accounting Principles Board (1959-1973); issued APB opinions.
 2. FASB—Financial Accounting Standards Board (superseded the APB in 1973 and still continuing); issues FASB statements.
 3. SEC—Securities and Exchange Commission (a federal regulatory agency; 1933 to date).
- D. The organizations that devote significant efforts to financial accounting and reporting are:
1. AICPA—the American Institute of Certified Public Accountants is composed primarily of CPAs in public practice. It is primarily interested in the problems of accounting practitioners and publishes the *Journal of Accountancy* (a periodic magazine).
 2. AAA—The American Accounting Association is composed primarily of accounting educators. It is concerned primarily with accounting education and accounting research (including accounting theory) and publishes the *Accounting Review* (a periodic magazine).

Part B—The Conceptual Framework and Implementation Principles of Accounting

- E. Accounting theory includes a set of concepts and implementation principles upon which accounting standards and procedures are based.
1. The FASB develops the conceptual framework for the accounting profession. To date this conceptual framework consists of the following:
 - (a) **FASB Accounting Concepts No. 1**—Objectives of financial reporting by business enterprises. The primary objective is to help statement users (the average prudent investor) make better decisions. Primarily this objective requires accounting information useful for **projecting cash flows** of the enterprise.
 - (b) **FASB Accounting Concepts No. 2**—Qualitative characteristics of accounting information. The qualitative characteristics enhance the usefulness of the **information** presented in the financial statements; they are:
 - (1) **Primary**
 - (a) **Relevance**—capacity to influence decisions.
 - Timeliness—in time to influence decisions.
 - Predictive value—has high value to influence decisions.
 - Feedback value—compare with prior expectations.
 - (b) **Reliability**—free from error, bias, and is believable.
 - Representational faithfulness—reports what it purports to report.
 - Verifiability—can be verified (i.e., checked).
 - Neutrality—free from bias.
 - (2) **Secondary**
 - (a) **Comparability**—comparison with other companies and other periods.
 - (b) **Consistency**—application of accounting principles in the same manner.

- (3) Threshold for recognition—constraints
 - (a) Materiality constraint—immaterial if exclusion would not affect decisions.
 - (4) Quality constraint—cost-benefit; cost of producing the information is less than the benefits.
- (c) **FASB Accounting Concepts No. 3—Elements of Financial Statements.** Implementation of the above concepts involves four groups of guidelines. These are the “building blocks” of the financial statements; they encompass definitions of:
- (1) **Income Statement Items:**
 - (a) Revenues—increase in net assets from sale of goods or services from ongoing major or central operations.
 - (b) Expenses—decrease in net assets from delivering goods or services from ongoing major or central operations.
 - (c) Gains—increase in net assets from peripheral or incidental transactions.
 - (d) Losses—decreases in net assets from peripheral or incidental transactions.
 - (2) **Balance Sheet:**
 - (a) Assets—probable future economic benefits from past transactions.
 - (b) Liabilities—probable future sacrifices from present obligations.
 - (c) Equity (i.e. owners’ equity)—total assets minus total liabilities.
 - (3) **Other:**
 - (a) Investments by owners—increases in net assets received from owners.
 - (b) Distributions to owners—decreases in net assets due to payments to owners.
 - (c) Comprehensive income—change in owners’ equity from nonowners (primarily from net income).
- (d) **FASB Accounting Concepts No. 4—Objectives of Financial Accounting Concepts for Nonbusiness Organizations.** This textbook does not include this topic.
- (e) **FASB Accounting Concepts No. 5—Recognition and Measurement in Financial Statements of Business Enterprises.** This statement looks to the future; it is not yet fully implemented. It envisions the following:
- (1) **A full, articulated, set of financial statements:***
 - Statement of financial position
 - Statement of earnings
 - Statement of comprehensive income and nonowner changes in equity
 - Statement of cash flows
 - Statement of investments by and distributions to owners

*See the illustrations in Chapter 1 of the textbook.

- (2) Recognition criteria
 - Definitions of recognition
 - Measurability
 - Relevance
 - Reliability
- (3) Guidelines in applying recognition criteria
 - Revenues and gains
 - Expenses and losses
 - Changes in assets and liabilities

2. Assumptions which set certain limits for accounting:

- (a) Separate entity assumption—account for a business as separate from its owners.
- (b) Continuity assumption—accounting assumes a going concern.
- (c) Unit of measure assumption—measure the effects of transactions in dollars.
- (d) Time period assumption—prepare periodic financial statements (e.g. annually).

3. Implementation principles, which specify guidelines for measuring and reporting financial information:

- (a) Cost principle—record completed transactions at their cash equivalent cost.
- (b) Revenue principle—recognize revenue when there is (a) a completed transaction and (b) when the earnings process is essentially completed.
- (c) Matching principle—recognize revenue for the period, then recognize all expenses incurred in earning that revenue.
- (d) Full-disclosure principle—report all of the relevant information about the economic affairs of the enterprise.
- (e) Implementation constraints:
 - (1) Materiality—amounts that are not material must be included in the financial statements but need not be reported in strict conformity with GAAP.
 - (2) Industry peculiarities—peculiarities and practices in an industry (such as banking) may warrant limited exceptions to strict GAAP (to avoid misleading inferences).
 - (3) Conservatism—when two alternative implementations are permitted, the alternative having the least favorable effect on income and/or assets should be used.

F. The discussion of each of the above items (E) given in the textbook (Chapter 1) should be studied to gain an understanding of each. Throughout the remaining chapters these items will be referred to frequently. At such times you should return to this chapter and read the cited parts.

Examination Questions and Problems For Self-Evaluation

These questions follow the chapter sequence. After reading the chapter and the above study guide outline, answer each of the questions to the best of your ability without again referring to the chapter. Next check your answers against those given in the back of this study guide. This process should provide a valuable guide for deciding about additional study of the chapter.

1. Match the following by entering the appropriate letters to the left.

- | | |
|---|---|
| ___(1) AICPA | A. Reports inflows and outflows of funds during the period. |
| ___(2) SEC | B. Reports on operations during the period. |
| ___(3) Statement of changes in financial position | C. Reports financial position at a specific date. |
| ___(4) CPA | D. Generally accepted accounting principles. |
| ___(5) Income statement | E. Independent certified public accountants. |
| ___(6) AAA | F. Organization that currently sets standards. |
| ___(7) FASB | G. American Institute of Certified Public Accountants. |
| ___(8) General purpose financial statements | H. Securities and Exchange Commission. |
| ___(9) GAAP | I. Accounting organization dominated by accounting educators. |
| ___(10) Balance sheet | J. Financial reports designed primarily for external decision makers. |

2. Match the following by entering the appropriate letters to the left:

- | | |
|--|--|
| ___(1) Accounting theory | A. Specifies objectives of financial reporting. |
| ___(2) Financial statement users | B. To assist statement users to make better economic decisions. |
| ___(3) Qualitative characteristics of financial statements | C. Makes accounting information more useful for decision makers. |
| ___(4) FASB Concepts No. 1 | D. Threshold for recognition. |
| ___(5) FASB Concepts No. 2 | E. Specifies the elements of financial statements. |
| ___(6) FASB Concepts No. 3 | F. Recognition and measurement in financial statements. |
| ___(7) FASB Concepts No. 5 | G. The average prudent investor. |
| ___(8) Primary objective of financial statements | H. Specifies the qualitative characteristics of accounting information. |
| ___(9) Relevance | I. A coherent set of conceptual and practical principles for a field of inquiry. |
| ___(10) Materiality | J. A function of timeliness, predictive value, and feedback value. |

3. Match the following by entering the appropriate letters to the left:

- | | |
|--------------------------------|--|
| ____(1) Expenses | A. Inflows of assets or settlement of liabilities from the entity's ongoing or central operations. |
| ____(2) Assets | B. Probable future economic benefits owned or controlled by the entity as a result of past transactions or events. |
| ____(3) Revenues | C. Increases in net assets of an entity from past transactions or events. |
| ____(4) Distribution to owners | D. Probable future sacrifices of economic benefits arising from past transactions or events. |
| ____(5) Liabilities | E. Increases in net assets from incidental transactions. |
| ____(6) Gains | F. Outflows or other using up of assets or incurrences of liabilities because of the entity's ongoing or central operations. |
| ____(7) Investments by owners | G. Decreases in net assets of the entity from incidental transactions (except expenses and distributions to owners). |
| ____(8) Losses | H. Decreases in net assets due to payments to owners. |

4. Match the following by entering the appropriate letters to the left:

- | | |
|------------------------------------|---|
| ____(1) Separate entity assumption | A. The calendar constraint; accounting measures and reports on the economic elements of the entity for a series of short-time periods (such as a year). |
| ____(2) Continuity assumption | B. Accounting measures and reports in terms of the monetary unit of the country. |
| ____(3) Unit of measure assumption | C. Each entity is considered to be an accounting unit separate and apart from its owners and other entities. |
| ____(4) Time period assumption | D. The entity is assumed for accounting purposes to be a "going concern." |

5. Match the following by entering the appropriate letters to the left:

- | | |
|----------------------------------|---|
| ___(1) Cost principle | A. Financial reports should disclose the relevant information relating to the economic affairs of the entity. |
| ___(2) Revenue principle | B. Specifies the amount and timing of revenue that should be recognized. |
| ___(3) Matching principle | C. Unique characteristics of an industry may warrant limited exceptions to strict GAAP. |
| ___(4) Full-disclosure principle | D. The market value of what is given up provides reliable evidence of the cost of the item acquired. |
| ___(5) Conservatism | E. Revenues are recognized then the expenses incurred in generating that revenue should be determined. |
| ___(6) Materiality | F. Use the GAAP alternative that has the least favorable effect on income and/or net assets. |
| ___(7) Industry peculiarities | G. Items whose amounts are not sufficiently large need not be reported in strict conformity with GAAP. |

6. T F Under the materiality threshold, items that are very small in amount need not be accounted for and reported at all.

7. Currently, the three required financial statements are:

- (a) _____
- (b) _____
- (c) _____

8. The full-disclosure principle requires that the financial statements place _____ over _____.

9. In respect to the matching principle, complete the following:

			<i>Record As</i>
Costs	→	Future benefits	(a) _____
Incurred	→	Current benefits	(b) _____
	→	No benefits	(c) _____

10. Revenue is measured as the market value of the resources received or the product or service given, whichever is the more

Review—The Accounting Model and Information Processing

Study Suggestions for the Chapter

This is a review chapter; it adds very little new material to what should be learned from a complete course in the fundamentals of financial accounting. Your study of this chapter should be a comprehensive overview of the **information processing cycle** used in all accounting systems. Special attention should be given to the **accounting model** and the purpose of **adjusting** and **closing** entries. The examples given in the textbook should be carefully studied as well as the interrelationships among the various steps in the information processing cycle. One or more of the comprehensive problems at the end of the chapter should be worked.

Study Outline of the Chapter

Part A—The Accounting Model and Information Processing During the Accounting Period

- A. The accounting model is comprised of three submodels which relate to the three required financial statements:
 - 1. **Financial position** model: $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$
 - 2. **Results of operations** model: $\text{Revenues} - \text{Expenses} = \text{Net Income}$
 - 3. **Changes in financial position** model: $\text{Funds inflows} - \text{Funds Outflows} = \text{Net Changes in Funds}$
- B. Fundamentally, all transactions and other events entered in an accounting system are recorded in terms of the **financial position model**; the **debit/credit concept** is superimposed on it to record increases and decreases, in this way:

Basic Model	}	→	Assets		=	Liabilities		+	Owners' Equity	
			Debit	Credit		Debit	Credit		Debit	Credit
Debit/Credit Model	}	→	+	-	=	-	+	+	-	+
									Decreases:	Increases:
									—Withdrawals	—Investments
									—Expenses	—Revenues

- C. **Accounting Information Processing Cycle**—this cycle is the **normal** sequential phases in an accounting system that are followed each period from the transactions, to the financial statements, and finally to the preparation of the accounts for the start of the next period. In this context, balance sheet accounts are called **permanent** accounts and income statement accounts are called **temporary** accounts (they are closed at the end of each accounting period).

The Accounting Information Processing Cycle

The sequential phases of the accounting information processing cycle are:

Completed during the accounting period:

1. **Collecting** original economic data concerning each transaction as each one occurs.
2. **Transaction analysis**; analysis of each transaction as it occurs to determine the economic impact on the entity in terms of the basic financial position model (Assets = Liabilities + Owners' Equity).
3. **Journalizing** the results of transaction analysis by entering the results in the **journal** in chronological order (and in terms of debits = credits).
4. **Posting** the entries in the journal to the various accounts in the **ledger** (reclassification of the data from chronological order to accounts).

End of the period:

5. Prepare and **Unadjusted trial balance** from the ledger (a listing of all accounts and the debit or credit balance of each one).
6. Prepare a supplementary **worksheet** as a **guide** to be used for preparing the financial statements, and to record the adjusting and closing processes in the accounts.
7. Prepare the **financial statements**; the balance sheet and income statement. (A separate worksheet is used to prepare the statement of changes in financial position, see Chapter 23.)
8. Enter the **adjusting entries** in the journal and then post those entries to the ledger.
9. Enter the **closing entries** in the journal and then post those entries to the ledger.
10. Prepare a **post-closing trial balance**; a listing of all accounts and the balance of each. Only the balance sheet accounts will appear in this trial balance.

Start of next period:

11. Journalize and post any **reversing entries** that will facilitate subsequent entries. This is an optional phase.

- D. **Adjusting entries**—entries that are made at the end of the accounting period to: (1) record events (such as depreciation expense) which have not yet been reflected in the accounts during the period and (2) separate the **permanent** (balance sheet) and **temporary** (income statement) elements of certain “mixed” accounts so that the revenue and matching principles are satisfied (such as the adjusting entry for expired insurance). Adjusting entries are required for three situations—deferred items, accrued items, and estimated items.

DEFERRED ITEMS—Items for which the recognition of expense or revenue must be in an accounting period after the entity pays or receives cash, respectively:

1. **Prepaid expense**—an expense paid in advance of the period(s) in which it can be properly recognized as expense on the income statement. Examples are insurance and supplies purchased, but not expired or used by the end of the accounting period. In these instances, the prepaid asset (balance sheet element) and the expense (income statement element) must be separated and correctly reflected in the accounts.

Example: The prepaid insurance account reflects a \$900 debit balance at the end of the year (Dec. 31, 19A), two-thirds of which expired (as expense) during the year, 19A

Adjusting entry on Dec. 31, 19A (end of the current accounting period):

Insurance expense	600	
Prepaid insurance		600

Note: This entry leaves the balance sheet element of \$300 in the prepaid insurance account (an asset) and recognizes the income statement (expense) element.

2. **Revenue collected in advance** (also called deferred revenue)—a revenue collected in advance of the period(s) in which it can be properly recognized as realized revenue on the income statement. In these situations the total amount collected in advance must be separated into two elements: (a) the liability for the future obligation to provide the occupancy in the example that follows (the balance sheet liability element), and (b) that part of the revenue earned during the current period (the income statement element). This requires an adjusting entry.

Example: On April 1, 19A, rent revenue of \$4,800 for twelve months (through March 31, 19B, of the next accounting period) was collected in advance. The collection was recorded; on April 1, 19A, as a debit to cash and a credit to rent revenue for the full amount, \$4,800.

Adjusting entry on December 31, 19A (end of the current accounting period):

Rent revenue ($\$4,800 \times 1/4$)	\$1,200	
Rent revenue collected in advance (or unearned rent revenue) (a liability)		1,200

Note: This entry leaves \$3,600 in the rent revenue account (i.e., the income statement element for the current period) and recognizes \$1,200 as the balance sheet element (a current liability for the obligation to provide future occupancy).