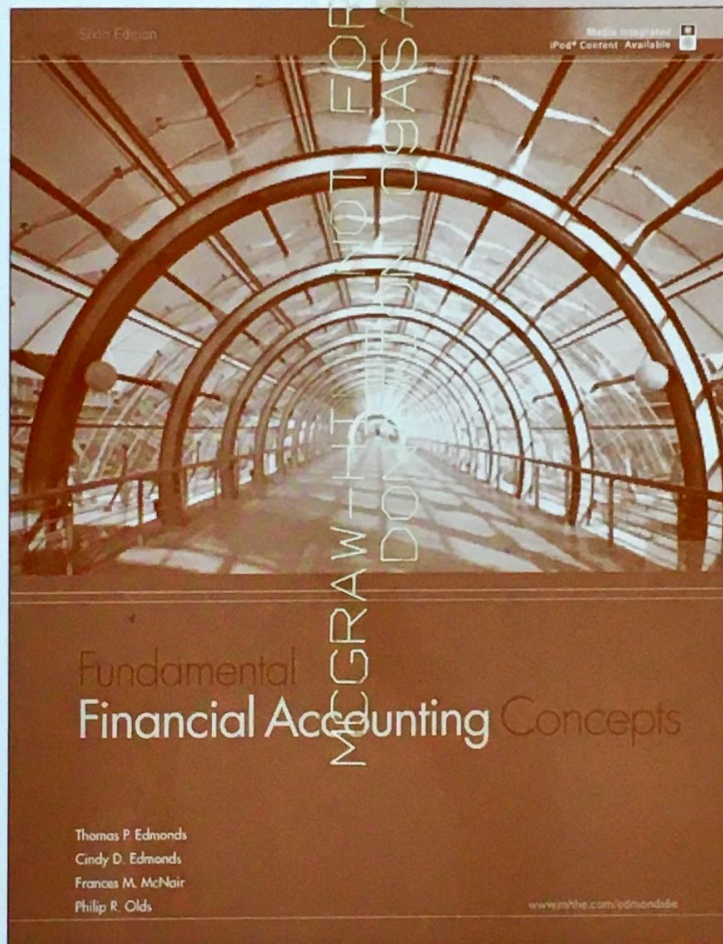


# Study Guide

for use with



Prepared by  
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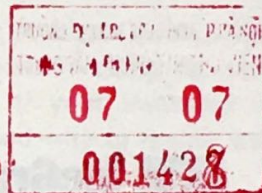


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## Fundamental Financial Accounting Concepts

Sixth Edition



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## Introduction

### How to Use This Study Guide

There are at least three different ways this study guide can be used to supplement the textbook. **First**, some students should find it helpful if used immediately after reading a given chapter in the text. The articulation problems, explained below, will especially be useful to help you determine if you have learned the basic concepts in a chapter.

**Second**, some students will find this guide helpful if used after a given chapter has been covered in class. Students often make mistakes working assigned homework problems and would like additional, similar problems to work for which they have solutions. The “exercise-type problems” in this guide provide that opportunity. Not only are the solutions provided, but they were written with students, not accounting instructors, in mind. This means that solutions are not simply presented, they are explained. Forms for answering these exercise-type problems are provided in this book. This not only saves you time, but also gives a little help if you are having trouble getting started on a problem.

**Third**, this study guide contains multiple-choice problems (with solutions) similar to those used by many accounting instructors on exams. Working the multiple choice problems is a good way to review for exams. Even if your instructor does not use multiple-choice questions, you will find these are a good way to review many different concepts from a chapter in a relatively short length of time.

As you can see, the study guide is not just for students who are having difficulty understanding accounting. However, regardless of why you are using this study guide, **you will get the best results if you do NOT look at the solutions before you make a serious effort to solve the problems on your own.**

### How to Study for This Accounting Course

If accounting instructors throughout the country were asked “What one thing can students do to improve their grade in the first accounting course?” their answer would be, **KEEP UP!** Unlike some disciplines, accounting is not a subject for which you can cram the night before an exam.

What should you do to keep up in this course?

First: **Read** the chapter thoroughly **before** it is covered in **class**. As you read the material be sure to **study the examples and illustrations in the text carefully**. Students often skip these because they take a considerable time to analyze, but understanding the examples included in each chapter is essential to being able to work assigned homework problems.



- Second:** **Work** assigned homework **problems before** they are reviewed in **class**. You will learn much more by attempting to work a problem on your own, even if you do not work it correctly, than you will learn by reviewing the instructor's solution to a problem that you have not attempted in advance.
- Finally:** Some students need to work more problems than are assigned as homework. If you do not understand the material in a chapter after the two steps described above, **work more problems!** This study guide can be helpful for this purpose.

Many students find it helpful to work in study groups. When you try to explain an accounting concept to another student, you often learn more than the student that you are trying to help. Study groups work best if each person studies some on their own before the group meeting.

If you are making a serious effort in this course, but continue to have difficulties, **talk to your instructor**. As instructors, we often have students talk to us after they have gotten too far behind to be helped. If you do not understand Chapter 3, for example, you cannot understand Chapter 4. Ask for help as soon as you have a problem.

## What is an Articulation Problem?

One of the first and easiest things to learn in accounting is that there are four basic financial statements. As explained in Chapter 1, these statements are the:

Balance Sheet  
Income Statement  
Statement of Cash Flows  
Statement of Changes in Stockholders' Equity

Each of these financial statements is based on a relatively simple model, which you might think of as an equation or format. Learning the basic format of each statement also is relatively simple.

One of the most difficult things for most students to learn, however, is the way the different financial statements interrelate. When an event occurs in a business, very seldom does that event affect only one of the statements; often all four are affected. For example, every event that affects the income statement also affects the balance sheet.

Accounting theorists refer to this interrelated characteristic as articulation. Accountants in the real world seldom use the term articulation, but they must constantly deal with the concept.

Accounting instructors sometimes ask non-accounting instructors, such as those who teach finance courses, "What accounting concept important to your course do students have the most trouble understanding?" They often answer, "Students do not



understand how the financial statements relate to each other." Understanding the concept of articulation is important to all business majors, not just accounting majors.

The text being used in your accounting course places great emphasis on the concept of articulation. In the textbook, this concept is usually presented in the context of the **horizontal model**. Most chapters in this study guide provide a series of articulation questions which will help you understand concepts related to the horizontal model presented in the text. You should study these questions early in your review of each chapter. If you do not understand most of the articulation questions presented, then you do not understand the concepts in that chapter as well as you should. Please take the time to review these questions carefully.

### **What is a Multiple True-False Problem?**

Multiple true-false (MTF) problems can be thought of as a cross between a traditional multiple-choice question and a traditional true-false question. Sometimes, a MTF item will present a set of facts (like a multiple-choice question). Next, four or five statements related to those facts will be presented and you are asked to indicate if **each** of these statements is true or false. Unlike a multiple-choice question in which one and only one choice is true, for a MTF item any number of the "choices" can be true or false.

This study guide also uses a second form of the MTF item. This form simply presents four or five statements about a common topic, and asks you to indicate if **each** item is true or false. Again, any number of the statements can be true or false. An advantage of MTF items is that they allow you to assess your understanding of many different facts and concepts about a topic more quickly than if a series of multiple-choice items were used. Even if your instructor does not use MTF items on his or her exams, you should find them helpful in studying for other types of exam questions.

**Good luck in your course!**

Philip R. Olds

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## Chapter One

### An Introduction to Accounting

#### Learning Objectives for the Chapter

After completing this chapter you should be able to:

1. Explain the role of accounting in society.
2. Distinguish among the different accounting entities involved in business events.
3. Name and define the major elements of financial statements.
4. Describe the relationships expressed in the accounting equation.
5. Record business events in general ledger accounts organized under the accounting equation.
6. Explain how the historical cost and reliability concepts affect amounts reported in financial statements.
7. Classify business events as asset source, use, or exchange transactions.
8. Use the general ledger account information to prepare four financial statements.
9. Record business events using a horizontal financial statements model.
10. Explain the price-earnings ratio (Appendix).

#### Brief Explanation of the Learning Objectives

##### 1. Explain the role of accounting in society.

Many decisions made by individuals, businesses, not-for-profit entities, and governments are based on financial information. Accounting is the profession responsible for developing much of that financial information.

##### 2. Distinguish among the different accounting entities involved in business events.

One important principle of accounting is the separate entity assumption. Among other things, this means that accountants consider the business entity to be separate from its owners. It is also important to remember that business events always involve at least two entities. Be sure you understand which entity's financial statements you are being asked about. For example, if Smith Company provides tax advice to Jones Company, Smith will recognize revenue, but Jones will recognize an expense.

##### 3. Name and define the major elements of financial statements.

There are nine elements of financial statements discussed in this chapter: *assets*, *liabilities*, *equity*, (which is subdivided into *common stock* and *retained earnings*), *revenues*, *expenses*, *net income*, and *distributions*.



Below is a brief explanation of these elements.

Assets: Things with future economic value to the business.

Liabilities: Claims against assets made by non-owners.

Stockholders' Equity: *Common stock* is that portion of equity resulting from direct investment by the owners. *Retained earnings* is that portion of owners' equity resulting from *net income* the business has earned but has not distributed to the owners.

Revenues: An increase in assets that results from the business providing services (or selling goods) to customers. (In Chapter 3 it will be shown that revenues can result in a reduction of liabilities as well as an increase in assets.)

Expenses: A reduction in assets that the business incurred in the hopes of producing revenues. (In Chapter 2 it will be shown that expenses can result in increased liabilities as well as a reduction in assets.)

Net Income Revenues - expenses = net income. A positive net income increases retained earnings. A negative net income, called a net loss, decreases retained earnings.

Distributions When a business has earned net income it may choose to keep these earnings in the business, or to pay out part or all of the earnings to the owners of the business. If the business is a corporation, the distributions are called dividends. Because the payment of distributions is not expected to generate revenue for the business entity, they are not considered expenses, but they do reduce retained earnings.

#### 4. Describe the relationships expressed in the accounting equation.

The most common way of stating the accounting equation is:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

*Equity* refers to the owners' claims against assets. Generically, equity is often referred to as *owners' equity*, but in a corporation the term most commonly used is *stockholders' equity*, and this is the term used throughout this course. The relationships that exist among the three variables in the accounting equation are like those of any other algebraic equation. If the amount on one side of the equation are increased or decreased, the amounts on the other side must increase or decrease by the same amount.



**5. Record business events in general ledger accounts organized under an accounting equation.**

This is done with the use of the self-study problems presented below. The articulation problems are especially intended to help you accomplish this objective, but remember, the articulation problems focus on broad account types such as assets. The general ledger accounts are more detailed, and include numerous different types of asset, liability, and stockholders' equity accounts.

**6. Explain how the historical cost and reliability concepts affect amounts reported in financial statements.**

Historical cost refers the amount that was paid for something when it was originally purchased. Fair market-value, or current value, refers to what something is worth today. Accounting in the United States reports most assets and liabilities at their historical costs, not their current value. Decision makers would usually prefer to know an asset's current value rather than its historical cost, but determining current value can be expensive and inaccurate. Since accounting places great importance in reporting reliable information, historical cost, which is easily verified and thus more reliable, is reported in most situations.

**7. Classify business events as asset source, use, or exchange transactions.**

**Asset source:** An event that causes total assets to increase. There will be a corresponding increase in liabilities and/or stockholders' equity.

**Asset use:** An event that causes total assets to decrease. There will be a corresponding decrease in liabilities and/or stockholders' equity.

**Asset exchange:** An event that causes one asset to increase and another asset to decrease by the same amount. It is possible that more than two assets will be involved in such an event, but the net effect on assets will be that total assets do not change.

**8. Use the general ledger account information to prepare four financial statements.**

The four financial statements are:

Balance Sheet: A listing of the *assets, liabilities*, and components of *stockholders' equity* of a business as of a particular date.