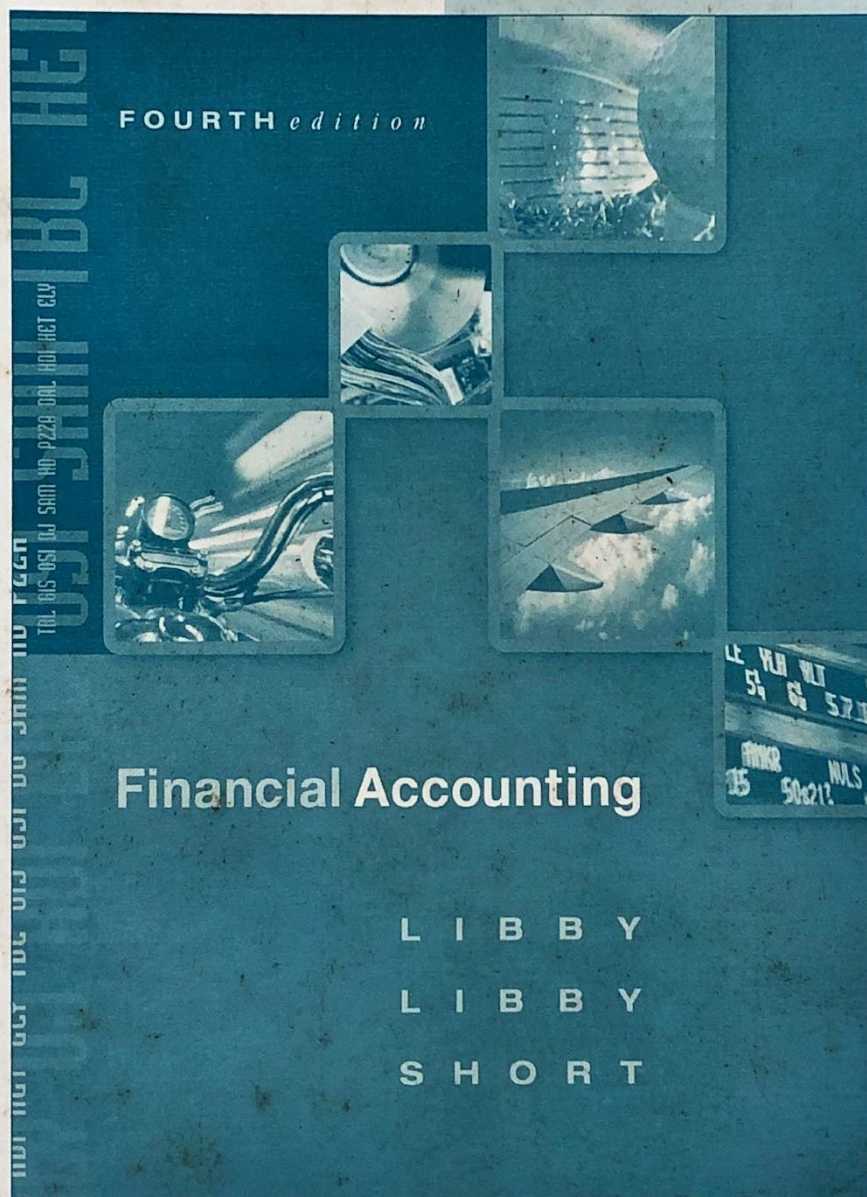


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Jeannie Folk

Study Guide

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Financial Accounting

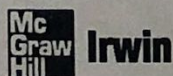
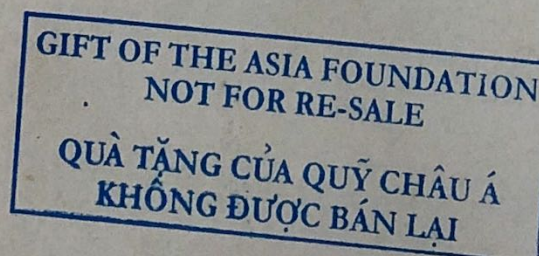
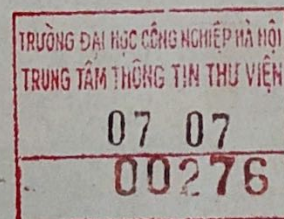
Fourth Edition

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Robert Libby, Patricia A. Libby, Daniel G. Short

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PREFACE

This Study Guide was developed to help you study more effectively. It incorporates many of the accounting survival skills essential to your success. It is designed to accompany the fourth edition of *Financial Accounting* by Libby, Libby and Short, but is not a substitute for your textbook. Each chapter of the Study Guide contains the following sections: *Organization of the Chapter*, *Chapter Focus Suggestions*, *Learning Objectives*, *Read and Recall Questions*, *Chapter Take-Aways*, *Key Ratio*, *Finding Financial Information*, *Self-Test Questions and Exercises*, *Solutions to Self-Test Questions and Exercises*, and *An Idea for Your Study Team*.

AN ACCOUNTING SURVIVAL PLAN

✓ **Preview**

Before you read a chapter in the textbook, preview it. Start by reading the *Organization of the Chapter*, *Learning Objectives* and *Chapter Focus Suggestions* sections that appear at the beginning of each chapter in this Study Guide. Next, thumb through the chapter in the textbook, noting the names of each of the section headings. Finally, read the textbook chapter summary and key terms list.

✓ **Read & Recall**

Now that you know what to expect, start reading. As you finish reading each section of the chapter in the textbook, answer the related *Read and Recall Questions* included in the Study Guide. Check your answers by referring to the related section in your textbook. If you were not able to answer all of the questions, read the related section of the chapter in your textbook again. When you can answer the *Read and Recall Questions*, you understand and can recall what you just read. To move that information into long-term memory, you'll need to practice and apply what you have learned.

✓ **Practice & Apply**

After reading the *Chapter Take-Aways*, *Key Ratio* and *Finding Financial Information* sections of the Study Guide, practice and apply what you have learned by completing the *Self-Test Questions and Exercises*. Match the key terms with the textbook definitions, answer each of the true-false and multiple choice questions, and complete each of the exercises. Periodically, check your answers using the *Solutions to Self-Test Questions and Exercises* section..

✓ **Review**

Use the Study Guide daily. The *Read and Recall Questions*, *Chapter Take-Aways* and *Key Ratio* sections can be used to review the essential concepts covered in each chapter. The *Self-Test Questions and Exercises* are likely to be similar to the materials you will encounter on exams.

Finally, remember that you're not alone. Develop your own support system by forming a study team with three or four of your classmates. Each chapter of the Study Guide contains an *Idea for Your Study Team*. You'll learn by discussion, and develop valuable interpersonal skills.

Don't forget to use positive self-talk as you visualize your success in this accounting class. You can do it!

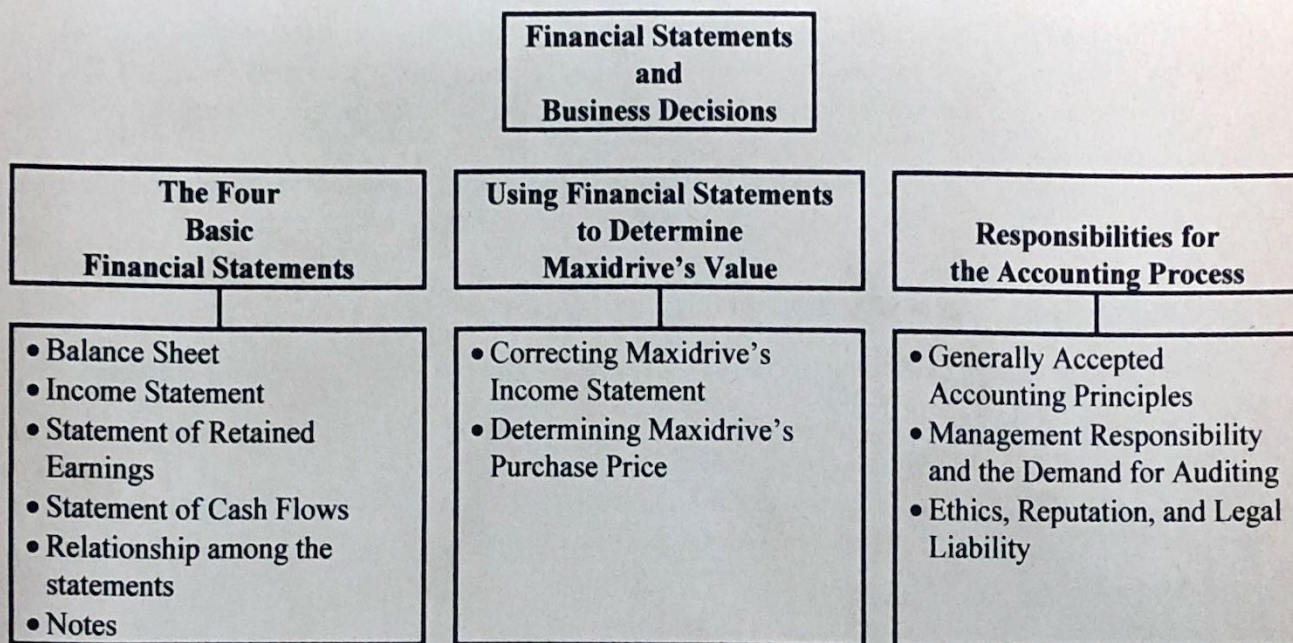
I would appreciate your comments and suggestions.

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CHAPTER 1

FINANCIAL STATEMENTS AND BUSINESS DECISIONS

ORGANIZATION OF THE CHAPTER



CHAPTER FOCUS SUGGESTIONS

Overview

This chapter describes the process that businesses use to communicate financial information to investors and creditors.

Terminology

If you have not yet worked in a business setting, you most likely will not be familiar with many of the terms used in this chapter. A solid understanding of the terminology used in this chapter is essential to your success. A listing of key terms appears at the end of the chapter; you should learn the definitions of each of these key terms. However, you should also make sure that you are familiar with other terms that are used in this chapter. These terms will be used throughout this course.

Financial Statement Matters

Four basic financial statements (that is, the income statement, statement of retained earnings, balance sheet and statement of cash flows) are used to communicate financial information to decision makers. This chapter provides an overview of each of the four basic financial statements. Memorize the equations for the financial statements so that you are able to easily identify the categories of items that are reported on each. Practice preparing all four financial statements. You will also be expected to understand how the financial statements are interrelated. As such, take the time to trace the common numbers from one financial statement to the next as you prepare the financial statements for a given company.

This chapter also introduces the parties involved in the communication process. Knowing which items are reported on each financial statement will help you to understand how decision makers use the financial statements.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- (LO 1) Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).
- (LO 2) Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.
- (LO 3) Distinguish the roles of managers and auditors in the accounting communication process.
- (LO 4) Appreciate the importance of ethics, reputation, and legal liability in accounting.

READ AND RECALL QUESTIONS

After you read each section of the chapter, answer the related Read and Recall Questions below.

LEARNING OBJECTIVE

After studying this section of the chapter, you should be able to:

1. Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).

UNDERSTANDING THE BUSINESS

THE PLAYERS

What do investors hope to gain when they purchase all or part of a company? What risks do they assume? Why do creditors lend money to companies? What risks do they assume?

THE BUSINESS OPERATIONS

What must you understand before you can understand a company's financial statements?

THE ACCOUNTING SYSTEM

What functions are performed by Maxidrive's accounting system? What two major groups use the reports produced by this accounting system? How does financial accounting differ from managerial accounting? Which of the two is the focal point of this text?

THE FOUR BASIC FINANCIAL STATEMENTS – AN OVERVIEW

What did Exeter Investors (Maxidrive's new owner) and American Bank (Maxidrive's largest creditor) use to learn more about the company before making their purchase and lending decisions? What assumption did they make when they used this information to make their purchase and lending decisions?

What do the four basic financial statements summarize? When are financial statements prepared?

THE BALANCE SHEET

What is the purpose of the balance sheet? What is another name for the balance sheet?

Structure

What four significant items are found in the heading of a balance sheet? What is the time dimension of the balance sheet? What unit of measure is used to prepare financial statements of U.S. companies?

What is the basic accounting equation? What is another name for the basic accounting equation?

Elements

What is an asset? How are assets initially measured on the balance sheet? What is a liability? How do liabilities arise? What is stockholders' equity? What two items are reported in the Stockholders' Equity section of the balance sheet?

FINANCIAL ANALYSIS

INTERPRETING ASSETS, LIABILITIES, AND STOCKHOLDERS' EQUITY ON THE BALANCE SHEET

Why did American Bank and Exeter assess Maxidrive's assets? Why are assets so important?

Why were Exeter Investors and American Bank interested in Maxidrive's debts? If a company is not able to pay its debts, what action can its creditors take?

Why was the amount of Maxidrive's stockholders' equity important to American Bank? If a company goes out of business and its assets are sold, how will the proceeds be used?

THE INCOME STATEMENT – Structure

What four significant items are found in the heading of an income statement? What is the time dimension of the income statement? What is an accounting period? What is the income statement equation?

Elements

What are revenues? When should revenues be reported on the income statement? Does the receipt of cash from a customer always coincide with the recording of revenue? Why or why not?

What do expenses represent? When are expenses reported on the income statement? Is it appropriate to correlate the recording of an expense with the payment of cash for that expense? Why or why not?

What is net income? When is a net loss reported? What term is used when total revenues equal total expenses?

FINANCIAL ANALYSIS

ANALYZING THE INCOME STATEMENT: BEYOND THE BOTTOM LINE

Why do investors (such as Exeter) and creditors (such as American Bank) closely monitor a firm's net income?

STATEMENT OF RETAINED EARNINGS – Structure

What four significant items are found in the heading of a statement of retained earnings? What is the time dimension of the statement of retained earnings? Does net income increase or decrease the balance of retained earnings? Does the declaration of dividends increase or decrease the balance of retained earnings? What is the retained earnings equation?

FINANCIAL ANALYSIS

Interpreting Retained Earnings

What is an important source of financing for companies (such as Maxidrive)? Why do creditors (such as American Bank) closely monitor a firm's retained earnings statement?

STATEMENT OF CASH FLOWS–Structure

What four significant items are found in the heading of a statement of cash flows? What is the time dimension of the statement of cash flows? Why aren't reported revenues always equal to the amount of cash collected from customers? Why aren't reported expenses always equal to the cash paid out during the period? What is the statement of cash flows equation?

Elements

What are cash flows from operating activities? What are cash flows from investing activities? What are cash flows from financing activities? What is the cash flow statement equation?

FINANCIAL ANALYSIS

Interpreting the Cash Flows Statement

What do analysts believe regarding the usefulness of the statement of cash flows? Which section of the statement do bankers consider the most important? Why? Why are stockholders interested in the company's cash flows from operations?

RELATIONSHIPS AMONG THE STATEMENTS

Which line on the income statement carries through to the statement of retained earnings? Which line on the statement of retained earnings appears on the balance sheet? Which line on the balance sheet appears on the statement of cash flows?

NOTES

Why are the notes (or footnotes) to the financial statements so important? What type of information is provided by each of the three types of notes to the financial statements?

FINANCIAL ANALYSIS

Management Uses of Financial Statements

How do the managers of a company (or firm) make direct use of the firm's financial statements?

USING FINANCIAL STATEMENTS TO DETERMINE MAXIDRIVE'S VALUE – CORRECTING MAXIDRIVE'S INCOME STATEMENT

What two types of errors did Exeter find in Maxidrive's financial statements?

DETERMINING THE PURCHASE PRICE FOR MAXIDRIVE

What factors did Exeter consider when deciding on a purchase price for Maxidrive? What is one method that is used to estimate the value of a company?

What does the price/earnings (PE) ratio measure? All others things equal, what does a high P/E ratio mean? How is the P/E ratio computed? How did Exeter Investors use this ratio to estimate its loss?

LEARNING OBJECTIVE

After studying this section of the chapter, you should be able to:

2. Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.

RESPONSIBILITIES FOR THE ACCOUNTING COMMUNICATION PROCESS

What do decision makers need to understand before using accounting information? What is the name of the measurement rules that are used to develop accounting information?

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

How are Generally Accepted Accounting Principles Determined?

What was created when the Securities Exchange Acts of 1933 and 1934 were passed into law by Congress? What function does the Securities and Exchange Commission (SEC) perform? What group has the primary responsibility to work out the detailed rules that become generally accepted accounting principles (GAAP)?

Why is GAAP Important to Managers and External Users?

Companies incur the cost of preparing financial statements and bear the major economic consequences of their publication. What are the three major potential economic consequences?

INTERNATIONAL PERSPECTIVE – Are Generally Accepted Accounting Principles Similar in Other Countries?

Is there one set of generally accepted accounting principles in use throughout the world? What is the International Accounting Standards Board attempting to accomplish? Until their goal is reached, what must managers and users do in order to successfully interpret financial statements?

LEARNING OBJECTIVE

After studying this section of the chapter, you should be able to:

3. Distinguish the roles of managers and auditors in the accounting communication process.

MANAGEMENT RESPONSIBILITY AND THE DEMAND FOR AUDITING

Who has the primary responsibility for the information that is presented in a company's financial statements? What steps do managers take to ensure the accuracy of the company's records? What section of a company's annual report reiterates these responsibilities?

What does an audit report describe? Who can issue an audit report? What does an audit involve? What does an independent CPA do while performing an audit? What happens when an audit, the best protection available to the public, fails?

LEARNING OBJECTIVE

After studying this section of the chapter, you should be able to:

4. Appreciate the importance of ethics, reputation, and legal liability in accounting.

ETHICS, REPUTATION AND LEGAL LIABILITY

What is necessary if financial statements are to be of any value to decision makers?

Why does the American Institute of Certified Public Accountants require all of its members to adhere to a professional code of ethics and professional auditing standards?

EPILOGUE

What are the two most common forms of financial statement fraud?

CHAPTER SUPPLEMENT A *(Determine whether you are responsible for this supplement.)***Types of Business Entities**

What is a sole proprietorship? What is a partnership? What is a corporation? What are the characteristics of each of the three types of business? What is the dominant form of business organization in the United States? Why is it the dominant form?

CHAPTER SUPPLEMENT B *(Determine whether you are responsible for this supplement.)***Employment in the Accounting Profession Today**

What requirements must be met before an accountant may be licensed as a Certified Public Accountant? What three types of services are performed by accounting firms?

CHAPTER TAKE-AWAYS

1. ***Recognize the information conveyed in each of the four basic financial statements and the way that it is used by different decision makers (investors, creditors, and managers).***

The *balance sheet* is a statement of financial position that reports dollar amounts for the assets, liabilities, and stockholders' equity at a specific point in time.

The *income statement* is a statement of operations that reports revenues, expenses, and net income for a stated period of time.

The *statement of retained earnings* explains changes to the retained earnings balance that occurred during the reporting period.

The *statement of cash flows* reports inflows and outflows of cash for a specific period of time.

The statements are used by investors and creditors to evaluate different aspects of the firm's financial position and performance.

2. ***Identify the role of generally accepted accounting principles (GAAP) in determining the content of financial statements.***

GAAP are the measurement rules used to develop the information in financial statements. Knowledge of GAAP is necessary for accurate interpretation of the numbers in financial statements.

3. ***Distinguish the roles of managers and auditors in the accounting communication process.***

Management has primary responsibility for the accuracy of a company's financial information. Auditors are responsible for expressing an opinion of the fairness of the financial statement presentations based on their examination of the reports and records of the company.

4. ***Appreciate the importance of ethics, reputation, and legal liability in accounting.***

Users will have confidence in the accuracy of financial statement numbers only if the people associated with their preparation and audit have reputations for ethical behavior and competence. Management and auditors can also be held legally liable for fraudulent financial statements and malpractice.

FINDING FINANCIAL INFORMATION

Balance Sheet

Assets = Liabilities + Stockholders' Equity

Income Statement

Revenues

– Expense

Net Income

Statement of Retained Earnings

Retained Earnings, beginning of the period

+ Net Income

– Dividends

Retained Earnings, end of the period

Statement of Cash Flows

+/- Cash Flow from Operating Activities

+/- Cash Flow from Investing Activities

+/- Cash Flow from Financing Activities

Net Change in Cash

SELF-TEST QUESTIONS AND EXERCISES

MATCHING

Match each of the key terms listed below with the appropriate definition found in the glossary:

___ Accounting	___ Income Statement
___ Accounting Entity	___ Notes (Footnotes)
___ Accounting Period	___ Report of Independent Accountants (Audit Report)
___ Assurance Services	___ Report of Management
___ Audit	___ Securities and Exchange Commission (SEC)
___ Balance Sheet	___ Statement of Cash Flows
___ Basic Accounting Equation	___ Statement of Retained Earnings
___ Financial Accounting Standards Board (FASB)	
___ Generally Accepted Accounting Principles (GAAP)	

- A. Indicates management's primary responsibility for financial statement information and the steps taken to ensure the accuracy of the company's records.
- B. Reports the revenues less the expenses of the accounting period.
- C. $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
- D. Provide supplemental information about the financial condition of a company, without which the financial statements cannot be fully understood.
- E. The organization for which financial data are to be collected (separate and distinct from its owners).
- F. The U.S. government agency that determines the financial statements that public companies must provide to stockholders and the measurement rules that they must use in producing those statements.
- G. A system that collects and processes (analyzes, measures, and records) financial information about an organization and reports that information to decision makers.
- H. The private sector body given the primary responsibility to work out the detailed rules that become generally accepted accounting principles.
- I. An examination of the financial reports to ensure that they represent what they claim and conform with generally accepted accounting principles.
- J. Reports the financial position (assets, liabilities, and stockholders' equity) of an accounting entity at a point in time.
- K. The measurement rules used to develop the information in financial statements.
- L. Describes the auditors' opinion of the fairness of the financial statement presentations and the evidence gathered to support that opinion.
- M. Reports inflows and outflows of cash during the accounting period in the categories of operations, investing, and financing.
- N. The time period covered by the financial statements.
- O. Reports the way that net income and the distribution of dividends affected the financial position of the company during the accounting period.
- P. Independent professional services that improve the quality of information for decision makers.