

Chapter 2

Constructing Financial Statements

Learning Objectives – Coverage by Question

	True/False	Multiple Choice	Exercises	Problems	Essay Questions
LO1 Describe and construct the balance sheet and understand how it can be used for analysis.	1-4	1, 3-5, 7, 21	1, 2, 5, 10, 13	1, 4	1-3
LO2 Use the financial statement effects template (FSET) to analyze transactions.	5	6, 9, 14, 15, 17	6, 7	5, 6	
LO3 Describe and construct the income statement and discuss how it can be used to evaluate management performance.	6, 7	8, 10-12	3, 8, 12	2, 3	
LO4 Explain revenue recognition, accrual accounting, and their effects on retained earnings.	8, 9	9, 12-14	7, 10	2, 5, 6	
LO5 Illustrate equity transactions and the statement of stockholders' equity.	10, 11	2	4, 5, 9-11, 13		
LO6 Use journal entries and T-accounts to analyze and record transactions.	12, 13	16, 17	6	5, 6	
LO7 Compute net working capital, the current ratio, and the quick ratio, and explain how they reflect liquidity.	14, 15	18-20	14, 15		

Chapter 2: Constructing Financial Statements

True/False

Topic: Assets

LO: 1

1. Companies may *not* report internally created assets, such as the value of a successful marketing campaign, design innovations and a highly motivated work force on their balance sheets.

Answer: True

Rationale: Even though these “assets” probably provide future benefits to the company that will be reflected in the company’s market value and in future revenues, these amounts cannot be reliably measured. They are excluded from the balance sheet under GAAP.

Topic: Historical cost

LO: 1

2. Assets such as inventory and property, plant, and equipment are reported on the balance sheet at their current market value.

Answer: False

Rationale: These assets are generally reported at historical cost.

Topic: Reporting of assets

LO: 1

3. Assets are listed on the balance sheet in order of liquidity and liabilities are listed in order of amount.

Answer: False

Rationale: Assets are reported in the order of liquidity which reflects the ease of converting into cash. Receivables are reported before inventories, and inventories before PPE. Liabilities are reported in order of maturity, with current liabilities expected to be paid within one year or within the operating cycle, and long-term liabilities expected to be paid over a longer period of time.

Topic: The double-entry accounting system

LO: 1

4. Under the double-entry accounting system, no more than two accounts can be affected by each transaction.

Answer: False

Rationale: Each transaction recorded under the double-entry accounting system must affect at least two accounts. It can affect more than two.

Topic: Transaction analysis

LO: 2

5. If Howard, Inc. purchased inventory on credit from Roan Company, then the transaction recorded by Howard would include an increase in a liability and an increase in asset.

Answer: True

Rationale: The transaction recorded by Howard would include an increase to an asset (inventory) and an increase to a liability (accounts payable).

Topic: Reporting financial performance

LO: 3

6. Operating expenses include interest expense related to a company's financing activities.

Answer: False

Rationale: Interest expense is considered to be a nonoperating expense.

Topic: Reporting financial performance

LO: 3

7. The income statement is also called the statement of earnings.

Answer: True

Rationale: Another name for the income statement is the statement of earnings.

Topic: Accrual accounting

LO: 4

8. Accrual accounting recognizes revenues only when cash is received and expenses only when cash is paid.

Answer: False

Rationale: Accrual accounting refers to the recognition of revenue when earned and the matching of expenses when incurred. The recognition of revenues and expenses does not always relate to the receipt or payment of cash.

Topic: Matching principle

LO: 4

9. Under the matching principle, the cost of inventory should be reported as an expense in the income statement when it is purchased, even if it is purchased on credit and will not be paid until the next reporting period.

Answer: False

Rationale: Under the matching principle, the cost of inventory should only be reported as expense in the period in which it is used up, typically at the point of sale. Purchased inventories that have not yet been sold are reported as assets. Unpaid amounts to suppliers are reported as liabilities.

Topic: Analyzing and recording equity transactions

LO: 5

10. If Umbrella Company paid \$2,000 cash dividends to its shareholders, retained earnings would be reduced by \$2,000.

Answer: True

Rationale: A cash dividend results in a reduction of retained earnings.

Topic: Analyzing and recording equity transactions

LO: 5

11. If stockholders' equity is \$88,000 on January 1, 2016, and decreases to \$64,000 on December 31, 2016, this could only be due to a net loss of \$24,000.

Answer: False

Rationale: A reduction in stockholders' equity could also be due to a declared cash dividend.

Topic: Debit and credit system

LO: 6

12. A compound entry does not necessarily have to maintain total debits equal to total credits.

Answer: False

Rationale: A compound entry must adhere to the rule: total debits equal total credits.

Topic: T-account

LO: 6

13. The typical form of a T-account shows debits on the right and credits on the left.

Answer: False

Rationale: A T-account tracks debits on the left and credits on the right.

Topic: Net working capital

LO: 7

14. Net working capital = Current assets + Current liabilities

Answer: False

Rationale: Net working capital = Current assets less current liabilities.

Topic: Assessing Liquidity

LO: 7

15. Quick ratio is another name for a current ratio.

Answer: False

Rationale: The quick ratio differs from the current ratio in that the numerator only contains cash, short-term securities, and accounts receivable.

Multiple Choice

Topic: Current assets

LO: 1

1. Which one of the following is included in current assets?

- A) Accounts receivable
- B) Taxes payable
- C) Automobiles
- D) Common stock

Answer: A

Rationale: Accounts receivable is included in current assets as it represents amount owed by customers that are expected to be paid within one year or the operating cycle.

Topic: Stockholders' equity

LO: 5

2. Which of the following is *not* shown in the statement of stockholder's equity?

- A) Unearned revenue
- B) Dividends
- C) Retained earnings
- D) Common stock

Answer: A

Rationale: Unearned revenue is a liability that represents amounts collected in advance from customers. It is an obligation that must be satisfied with a future cash payment or delivery of goods or services.

Topic: Reporting of assets

LO: 1

3. Assets are recorded in the balance sheet in order of:

- A) Market value
- B) Historic value
- C) Liquidity
- D) Maturity

Answer: C

Rationale: Liquidity refers to the ease of conversion to cash. Current assets are to be used during the current operating cycle (starting with cash, short-term investments, accounts receivables, inventories and other assets). Market value and historic value refer to the measurement of assets. Maturity refers to the order in which liabilities are recorded in the balance sheet.

Topic: Liabilities

LO: 1

4. Which one of the following is *not* a current liability?

- A) Taxes payable
- B) Accounts payable
- C) Wages payable
- D) Wage expense

Answer: D

Rationale: Wages expense is an income statement account, not a balance sheet account. Current liabilities are amounts owed and due to be repaid within one year or within one operating cycle.

Topic: Reporting of assets

LO: 1

5. What are probable future sacrifices called and how are they reported?

- A) Assets on the balance sheet
- B) Stockholders' equity on the balance sheet
- C) Dividends on the statement of stockholders' equity
- D) Liabilities on the balance sheet

Answer: D

Rationale: Liabilities are probably future economic sacrifices resulting from a current or past event. They are obligations that must be satisfied with a future cash payment or delivery of goods or services.

Topic: Chart of accounts

LO: 2

6. Account titles are commonly grouped into what five categories in the chart of accounts?

- A) Current assets, Current liabilities, Noncurrent assets, Noncurrent liabilities, Stockholders' equity
- B) Assets, Liabilities, Equity, Revenue, Expenses
- C) Common stock, Additional paid-in capital, Treasury stock, Retained earnings, Accumulated other comprehensive income or loss
- D) Cash, Marketable securities, Accounts payable, Long-term debt, Common stock

Answer: B

Rationale: In the chart of accounts, account titles are commonly grouped into the five categories of: Assets, Liabilities, Equity, Revenues, and Expenses.

Topic: Stockholders' equity

LO: 1

7. Which one of the following *does not* impact retained earnings directly?

- A) Net income
- B) Net loss
- C) Dividends
- D) Stock issuances

Answer: D

Rationale: Stock issuances impact stockholders' equity through the common stock account.

Topic: Income statement

LO: 3

8. An income statement *does not* include which of the following?

- A) Operating expenses
- B) Cost of goods sold
- C) Retained earnings
- D) Sales

Answer: C

Rationale: Retained earnings represent accumulated earnings from previous accounting periods that has not been distributed to stockholders as dividends.

Topic: Effects of accrued wages

LO: 2, 4

9. An accrual of wages expense would produce what effect on the balance sheet?

- A) Increase liabilities and decrease equity
- B) Decrease liabilities and increase equity
- C) Increase assets and increase liabilities
- D) Decrease assets and decrease liabilities

Answer: A

Rationale: An accrual of wages expense produces an increase in wages payable (liability) and a decrease in retained earnings (stockholders' equity), resulting in a decrease of profit.

Topic: Gross profit

LO: 3

10. Sales less cost of goods sold equals:

- A) Net income
- B) Net profit margin
- C) Gross profit
- D) Gross profit margin

Answer: C

Rationale: Sales – Cost of goods sold = Gross profit.
The gross profit margin is gross profit divided by sales.

Topic: Reporting financial performance

LO: 3

11. Hopewell Industries recorded and paid \$1,800 advertising for the current month. Which occurred?

- A) Current assets increase.
- B) Gross profit decreases.
- C) Operating income decreases.
- D) Retained earnings increases.

Answer: C

Rationale: Assets (cash) decrease and Advertising Expense (an operating expense) increases, causing operating income to decrease.

Topic: Recognition of costs as expense

LO: 3, 4

12. As inventory and PPE assets on the balance sheet are consumed, they are reflected:

- A) As a revenue on the income statement
- B) As an expense on the income statement
- C) As common stock on the balance sheet
- D) Assets are never consumed

Answer: B

Rationale: As assets are consumed (used up), their cost is transferred into the income statement as an expense.

Topic: Analyzing and recording income statement transactions

LO: 4

13. Which of the following will properly record the payment of a one-year insurance policy?

- A) Increase assets and increase retained earnings
- B) Increase liabilities and decrease retained earnings
- C) Increase and decrease assets
- D) Decrease assets and decrease liabilities

Answer: C

Rationale: Prepaid insurance is increased and cash is decreased, both of which are assets.

Topic: Collection of a receivable

LO: 2, 4

14. Cash collected on accounts receivable would produce what effect on the balance sheet?

- A) Increase liabilities and decrease equity
- B) Decrease liabilities and increase equity
- C) Increase assets and decrease assets
- D) Decrease assets and decrease liabilities

Answer: C

Rationale: Cash collected on accounts receivable produces an increase in cash and a decrease in accounts receivable, both asset accounts. There is no impact on profit and on equity.

Topic: Transaction analysis

LO: 2

15. Which of the following is one effect of a purchase of \$1,000 of inventory on credit?

- A) It would increase liabilities by \$1,000
- B) It would decrease retained earnings by \$1,000
- C) It would decrease liabilities by \$1,000
- D) It would decrease cash asset \$5,000

Answer: A

Rationale: The purchase on credit creates an account payable. It would increase liabilities by \$1,000. In addition, the inventory account in the asset section of the balance sheet would also increase.

Topic: Journalizing and posting transactions

LO: 6

16. The Cash t-account has a beginning balance of \$64,000. During the year, \$488,000 was debited and \$498,000 was credited to the account.

What is the ending balance of cash?

- A) (\$10,000)
- B) \$74,000
- C) \$54,000
- D) Cannot be determined from the information given.

Answer: C

Rationale: $\$64,000 + \$488,000 - \$498,000 = \$54,000$

Topic: Journalizing and posting transactions

LO: 2, 6

17. On January 1, 2016, Lorraine Company paid a \$32,000 cash security deposit to rent office space.

Which of the following would be the correct journal entry to record this transaction?

- A) Rent expense 32,000
 Cash 32,000
- B) Security deposit 32,000
 Cash 32,000
- C) Cash 32,000
 Rent expense 32,000
- D) Cash 32,000
 Security deposit 32,000

Answer: B

Rationale: Security deposit is debited and Cash is credited for \$32,000.

Topic: Net working capital

LO: 7

18. Net working capital is defined as:

- A) Assets – liabilities
- B) Current assets
- C) Current assets – Current liabilities
- D) Market value – Book value

Answer: C

Rationale: Net working capital = Current assets – Current liabilities

Topic: Assessing liquidity

LO: 7

19. Which of the following statements is *true* regarding the current ratio?

- A) A company with a high current ratio cannot have liquidity problems
- B) A low current ratio suggests inefficient use of resources
- C) The current ratio can be improved by paying creditors immediately prior to the preparation of financial statements
- D) The current ratio presents a more conservative liquidity measure than does the quick ratio

Answer: C

Rationale: A current ratio can be manipulated by management and improved if creditors are paid immediately prior to the close of a financial statement period.

Topic: Assessing Liquidity

LO: 7

20. If Foster Toys has a current ratio of 2.5 and working capital of \$2,200,000, which of the following will cause both the current ratio and working capital to decrease?

- A) Paid accounts payable in the amount of \$60,000
- B) Recorded unpaid salaries in the amount of \$160,000
- C) Borrowed \$200,000 from a bank to be repaid in 90-days
- D) Purchased \$30,000 of inventory on credit

Answer: B

Rationale: Working capital will remain the same in A, C, and D. Only option B will show a decrease in both the current ratio and working capital.

Topic: Measuring assets

LO: 1

21. Which of the following is the justification of reporting certain assets at historical cost?

- A) Executory
- B) Reliability
- C) Relevance
- D) Accrual

Answer: B

Rationale: Historical cost is used because it is objective and reliable. It can easily be verified as it represents the cost originally paid.

Exercises

Topic: Balance sheet accounts

LO: 1

1. Identify the following as an asset (A), liability (L), or equity (E) by writing the letter of the correct classification in the space provided.

	Account	Classification
A.	Accounts payable	_____
B.	Office equipment	_____
C.	Accounts receivable	_____
D.	Common stock	_____
E.	Cash	_____
F.	Contributed capital	_____
G.		_____
.	Wages payable	_____
H.	Unearned revenue	_____

Answer:

- | | |
|--------------|--------------|
| A. Liability | E. Asset |
| B. Asset | F. Equity |
| C. Asset | G. Liability |
| D. Equity | H. Liability |

Topic: Balance sheet relations

LO: 1

2. Compute the missing amounts in the table below:

	Year 1	Year 2
Total assets	\$170,000	B
Common stock	A	\$7,200
Retained earnings	\$16,800	\$37,600
Total liabilities	\$125,200	\$72,000
Liabilities and equity	\$170,000	\$116,800

Answer:

- Liabilities and equity – equity = Liabilities
 $\$170,000 - \text{equity} = \$125,200$
 Equity = $\$44,800$

Common stock + retained earnings = Equity
 Common stock + $\$16,800 = \$44,800$
 Common stock = $\$28,000$
- Total assets = Liabilities and equity
 $\$? = \$116,800$
 Total assets = $\$116,800$

Topic: Prepare an income statement**LO: 3**

3. Prepare an income statement for the month ended July 31, 2016 for Bargain Books. Bargain's account balances for the month ending July 31, 2016 are:

Cash	\$ 2,800	Rent expense	\$33,200
Accounts receivable	37,000	Utilities expense	1,060
Office supplies	6,200	Salaries expense	32,000
Office equipment	58,300	Miscellaneous expenses	290
Land	140,000	Retained earnings, July 1	24,300
Sales	110,000	Common stock	152,250
Cash dividends	5,300	Accounts payable	29,600

Answer:

Bargain Books Income Statement For the Month Ended July 31, 2016		
Revenues		
Sales		\$110,000
Expenses		
Salaries expense	\$32,000	
Rent expense	33,200	
Utilities expense	1,060	
Miscellaneous. expense	<u>290</u>	
Total expenses		<u>66,550</u>
Net income		<u>\$43,450</u>

Topic: Prepare a statement of stockholders' equity**LO: 5**

4. Prepare a statement of stockholders' equity for the month ended July 31, 2016 for Bargain Books. Assume no changes in contributed capital during the month. Bargain's account balances for the month ending July 31, 2016 are:

Cash	\$ 2,800	Rent expense	\$33,200
Accounts receivable	37,000	Utilities expense	1,060
Office supplies	6,200	Salaries expense	32,000
Office equipment	58,300	Miscellaneous expenses	290
Land	140,000	Retained earnings, July 1	24,300
Sales	110,000	Common stock	152,250
Cash dividends	5,300	Accounts payable	29,600

Answer:

Bargain Books Statement of Stockholders' Equity For the Month Ended July 31, 2016			
	Contributed Capital	Retained Earnings	Total Equity
Balance, July 1, 2016	\$152,250	\$24,300	\$176,550
Common stock issued	0		0
Add: Net income		43,450	43,450
Less: Dividends	<u>0</u>	<u>(5,300)</u>	<u>(5,300)</u>
Balance, July 31, 2016	<u>\$152,250</u>	<u>\$ 62,450</u>	<u>\$214,700</u>

Net Income: $\$110,000 - \$32,000 - \$33,200 - 1,060 - \$290 = \$43,450$

Topic: Prepare a balance sheet**LO: 1, 5**

5. Prepare a balance sheet for Bargain Books as of July 31, 2016. Bargain's account balances for the month ending July 31, 2016 are:

Cash	\$ 2,800	Rent expense	\$33,200
Accounts receivable	37,000	Utilities expense	1,060
Office supplies	6,200	Salaries expense	32,000
Office equipment	58,300	Misc. expenses	290
Land	140,000	Retained earnings, July 1	24,300
Sales	110,000	Common stock	152,250
Cash dividends	5,300	Accounts payable	29,600

Answer:

Bargain Books Balance Sheet July 31, 2016			
Assets		Liabilities	
Cash	\$ 2,800	Accounts payable	\$ 29,600
Accounts receivable	37,000		
Office supplies	<u>6,200</u>	Equity	
Total current assets	46,000	Common stock	152,250
Office equipment	58,300	Retained earnings	<u>62,450</u>
Land	<u>140,000</u>	Total equity	214,700
Total noncurrent assets	<u>\$198,300</u>		
Total assets	<u>\$244,300</u>	Total liabilities and equity	<u>\$244,300</u>

Topic: Identifying transactions that yield statement effects**LO: 2, 6**

6. Provide an example of a transaction that creates each of following effects:

- Increase assets and increase equity
- Decrease asset and decrease liability
- Decrease asset and decrease equity
- Increase asset and increase liability

Answer:

- Owner invests cash into business
- Pay cash to settle a liability in accounts payable
- Business incurs an expense and it is paid with cash
- Business buys a new machine on credit

Topic: Transaction analysis

LO: 2, 4

7. Record the effects of each transaction or event in the table below:

Transaction	Balance Sheet						Income Statement			
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	
(1) Purchase \$16,000 of inventory on credit				=						=
(2) Employees earn \$12,000 in wages that are not paid in cash				=						=
(3) Paid \$8,000 cash for rent expense				=						=
(4) Collected \$96,000 cash from accounts receivable				=						=
(5) Paid \$28,000 cash toward accounts payable				=						=
(6) Received \$44,000 from cash sales				=						=

Answer:

Transaction	Balance Sheet						Income Statement			
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	
(1) Purchase \$16,000 of inventory on credit			+16,000 Inventory	=	+16,000 Accounts Payable					=
(2) Employees earn \$12,000 in wages that are not paid in cash				=	+12,000 Wages Payable			-12,000 Retained Earnings		-12,000
(3) Paid \$8,000 cash for rent expense	-8,000 Cash			=				-8,000 Retained Earnings		-8,000
(4) Collected \$96,000 cash from accounts receivable	+96,000 Cash		-96,000 Accounts Receivable	=						=
(5) Paid \$28,000 cash toward accounts payable	-28,000 Cash			=	-28,000 Accounts Payable					=
(6) Received \$44,000 from cash sales	+44,000 Cash			=				+44,000 Retained Earnings	+44,000 Sales Revenue	+44,000

Topic: Preparing income statement**LO: 3**

8. The following items and amounts are taken from the 2016 financial records of Retrieval Co.:

Security deposit.....	\$ 12,800	Salaries payable.....	\$ 12,000
Equipment.....	58,000	Common stock.....	21,000
Salaries expense.....	168,000	Supplies expense	18,800
Utilities expense.....	4,400	Retained earnings, Jan. 1, 2016.....	24,000
Dividends.....	30,400	Insurance expense.....	8,800
Accounts payable.....	40,800	Service revenue.....	300,000
Cash.....	39,600	Repair expense.....	18,000
Accounts receivable.....	39,000		

Prepare an income statement for the year ending December 31, 2016:

Answer:

Retrieval Co. Income Statement For the Year Ended December 31, 2016			
Revenues			
Service revenue		\$ 300,000	
Expenses			
Salaries expense	\$168,000		
Utilities expense	4,400		
Supplies expense	18,800		
Repair expense	18,000		
Insurance expense	<u>8,800</u>		
Total expense		<u>218,000</u>	
Net Income		<u>\$ 82,000</u>	

Topic: Preparing a statement of stockholders' equity**LO: 5**

9. The following items and amounts are taken from the 2016 financial records of Retrieval Co.:

Security deposit.....	\$ 12,800	Salaries payable.....	\$ 12,000
Equipment.....	58,000	Common stock.....	21,000
Salaries expense.....	168,000	Supplies expense	18,800
Utilities expense.....	4,400	Retained earnings, Jan. 1, 2016.....	24,000
Dividends.....	30,400	Insurance expense.....	8,800
Accounts payable.....	40,800	Service revenue.....	300,000
Cash.....	39,600	Repair expense.....	18,000
Accounts receivable.....	39,000		

Prepare a statement of stockholders' equity for Retrieval Co. for the year ending December 31, 2016. Assume no changes in common stock during the year.

Answer:

Retrieval Co. Statement of Stockholders' Equity For the Year Ended December 31, 2016			
	Contributed Capital	Retained Earnings	Total Equity
Balance, January 1, 2016	\$21,000	\$24,000	\$45,000
Common stock issued	0		0
Add: Net income		82,000	82,000
Less: Dividends	<u>0</u>	<u>(30,400)</u>	<u>(30,400)</u>
Balance, December 31, 2016	<u>\$21,000</u>	<u>\$ 75,600</u>	<u>\$ 96,600</u>

Net Income: \$300,000 – \$168,000 – \$4,400 – 18,800 – \$18,000 – \$8,800 = \$ 82,000

Topic: Preparing a balance sheet**LO: 1, 4, 5****10.** The following items and amounts are taken from the 2016 financial records of Retrieval Co.:

Security deposit.....	\$ 12,800	Salaries payable.....	\$ 12,000
Equipment.....	58,000	Common stock.....	21,000
Salaries expense.....	168,000	Supplies expense	18,800
Utilities expense.....	4,400	Retained earnings, Jan. 1, 2016.....	24,000
Dividends.....	30,400	Insurance expense.....	8,800
Accounts payable.....	40,800	Service revenue.....	300,000
Cash.....	39,600	Repair expense.....	18,000
Accounts receivable.....	39,000		

Prepare a balance sheet for Retrieval Co. for the year ending December 31, 2016.

Answer:

Net Income: \$300,000 – \$168,000 – \$4,400 – 18,800 – \$18,000 – \$8,800 = \$ 82,000

Retained earnings, December 31, 2016: \$24,000 + \$ 82,000 – \$30,400 = \$ 75,600

Retrieval Co. Balance Sheet December 31, 2016			
Assets		Liabilities	
Cash	\$ 39,600	Accounts payable	\$40,800
Accounts receivable	<u>39,000</u>	Salaries payable	<u>12,000</u>
Total current assets	78,600	Total liabilities	52,800
Security deposit	12,800	<i>Equity</i>	
Equipment	<u>58,000</u>	Common stock	21,000
Total noncurrent assets	70,800	Retained earnings	75,600
		Total equity	<u>96,600</u>
Total assets	<u>\$ 149,400</u>	Total liabilities and equity	<u>\$ 149,400</u>

Topic: Statement of stockholders' equity**LO: 5**

11. The records of Meadow Corp. show the following information after all transactions are recorded for 2016.

Notes payable	\$ 20,000	Supplies	\$ 29,000
Service fees earned	184,400	Cash	55,000
Supplies expense	38,800	Advertising expense	6,800
Insurance expense	14,000	Salaries expense	36,000
Miscellaneous expense	600	Rent expense	38,000
Common stock, January 1	22,000	Retained earnings, January 1	25,000
Accounts payable	7,200	Accounts receivable	6,400
Dividends	4,000	Equipment	60,000

Meadow raised \$24,000 cash through the issuance of additional common stock during the year. Based on this information, prepare Meadow's statement of stockholders' equity for the year ending December 31, 2016.

Answer:

Meadow Corp Statement of Stockholders' Equity For Year Ended December 31, 2016			
	Common Stock	Retained Earnings	Total Equity
Balance at January 1, 2016	\$22,000	\$25,000	\$47,000
Stock issuance	24,000		24,000
Dividends		(4,000)	(4,000)
Net income*		<u>50,200</u>	<u>50,200</u>
Balance at December 31, 2016	<u>\$ 46,000</u>	<u>\$71,200</u>	<u>\$ 117,200</u>

*\$50,200 = \$184,400 – \$38,800 – \$14,000 – \$600 – \$6,800 – \$36,000 – \$38,000

Topic: Preparing income statement from account balances**LO: 3**

12. On December 31, 2016, Sirius Corporation's records show the following selected amounts.

Cash	\$ 19,000	Cash dividends	\$ 2,000
Accounts receivable	4,000	Sales	84,000
Office supplies	12,000	Rent expense	20,000
Office equipment	40,000	Salaries expense	36,000
Accounts payable	16,000	Telephone expense	3,000
Common stock	2,000	Miscellaneous expense	8,000
Retained earnings, Dec. 31, 2016	62,000		

Prepare an income statement for Sirius for its year ending December 31, 2016.

Answer:

Sirius Corporation Income Statement For the Year Ended December 31, 2016		
Revenues		
Sales		\$ 84,000
Expenses		
Salaries expense	\$36,000	
Rent expense	20,000	
Telephone expense	3,000	
Miscellaneous expense	<u>8,000</u>	
Total expense		<u>67,000</u>
Net Income		<u>\$ 17,000</u>

Topic: Equity changes**LO: 1, 5**

13. At the end of 2016, Lumos Company reported the following amounts on its balance sheet:

Cash	\$ 56,200
Accounts receivable	104,800
Equipment	92,000
Land	240,000
Accounts payable	63,000
Common stock	190,000
Retained earnings	240,000

Answer each of the following independent questions:

- A. Assume that Lumos' stockholders' equity on January 1, 2016 was \$264,000. Lumos did not issue common stock during the year, but it paid \$36,000 cash in dividends. How much is Lumos' net income or loss for 2016?
- B. Assume that Lumos' stockholders' equity on January 1, 2016 was \$236,000, and that Lumos issued additional common stock of \$70,000 and paid \$44,000 in cash dividends before the end of 2016. What was Lumos' net income or net loss for 2016?

Answer:

A. Increase in equity (\$190,000 + \$ 240,000 – \$264,000)	\$ 166,000
Add: Dividends	<u>36,000</u>
Net Income for 2016	<u>\$ 202,000</u>
B. Increase in equity (\$190,000 + \$240,000 – \$236,000)	\$ 194,000
Add: Dividends	44,000
Less: Additional Investment	<u>(70,000)</u>
Net Income for 2016	<u>\$ 168,000</u>

Topic: Net working capital**LO: 7**

14. Lollipop, Inc. has \$2,400 net working capital and \$6,600 of current assets, what is the amount of the firm's current liabilities?

Answer:

Net working capital = current assets – current liabilities.

\$2,400 = \$6,600 – Current liabilities

Current liabilities = \$4,200

Topic: Operating cycle**LO: 7**

15. Companies strive to reduce operating cycles (time between paying cash for goods and receiving cash from customers). List 2 ways by which companies can achieve this.

Answer:

1. Increase trade credit to minimize the cash invested in inventories,
2. Reduce inventory levels from improved production systems and management,
3. Better underwriting and collection of receivables to reduce past due accounts,
4. Offer incentives to customers for early payment of receivables.

Problems

Topic: Balance sheet accounts

LO: 1

1. In the blank space beside each numbered balance sheet item, enter the letter of its balance sheet classification. If the item should not appear on the balance sheet, enter a Z in the blank.

_____ 1.	Cash	A.	Current assets
_____ 2.	Inventory	B.	Long-term investments
_____ 3.	Land	C.	Long-term assets
_____ 4.	Machine	D.	Intangible assets
_____ 5.	Building	E.	Current liabilities
_____ 6.	Income taxes payable in 30 days	F.	Noncurrent liabilities
_____ 7.	Utilities payable	G.	Equity
_____ 8.	Note receivable due in 30 days		
_____ 9.	Common Stock		
_____ 10.	Goodwill		
_____ 11.	Value of company logo		
_____ 12.	Wages expense		
_____ 13.	Value of land in excess of cost		
_____ 14.	Mortgage payable		
_____ 15.	Accounts receivable		

Answer:

1. A	9. G
2. A	10. D
3. C	11. Z
4. C	12. Z
5. C	13. Z
6. E	14. F
7. E	15. A
8. A	

Topic: Transaction analysis**LO: 3, 4**

2. Based on the following list of transactions, indicate their effect on Divine Dogs assets, liabilities and equity for his one month of operations.

- A. Divine buys a cooler and a George Foreman grill for \$1,200 cash.
- B. Divine takes out a loan for \$3,200.
- C. Divine buys 600 hot dogs at \$0.50 each, 500 buns at \$0.20 each, 800 cans of soft drinks at \$0.50 each and a huge bottle of ketchup for \$50.
- D. Divine sells 160 hot dog / drink combos for \$8 each.
- E. Divine records the product cost for the sales in (D) above, including ketchup, at \$1.50 each.
- F. Divine pays his hot dog salesmen \$800 for the month.
- G. Divine pays \$80 of his loan.

	Cash	Inventory	Equipment	Accounts Payable	Loans	Equity
A						
B						
C						
D						
E						
F						
G						

Answer:

	Cash	Inventory	Equipment	Accounts Payable	Loans Payable	Equity
A	(1,200)		+1,200			
B	+3,200				+3,200	
C	(850)	+850				
D	+1,280					+1,280
E		(240)				(240)
F	(800)					(800)
G	(80)				(80)	

C: $(600 \times \$0.50) + (500 \times \$0.20) + (800 \times \$0.50) + \$50.00 = \$850.00$

D: $160 \times \$8.00 = \$1,280$

E: $\$1.50 \times 160 = \240

Topic: Income statement relations**LO: 3**

3. Information concerning Nickolas' earnings for three years appears below.

Nickolas' Income Statement Information (\$ millions)			
Year	2016	2015	2014
Sales	\$22,750	\$20,258	
Cost of goods sold		9,372	7,166
Gross profit	8,986		(1,138)
Operating expenses		4,176	3,650
Other income (loss)	824		(178)
Net income	3,068	5,922	

Calculate the missing amounts.

Answer:

Nickolas' Income Statement Information (\$ millions)			
Year	2016	2015	2014
Sales	\$22,750	\$20,258	\$6,028
Cost of goods sold	13,764	9,372	7,166
Gross profit	8,986	10,886	(1,138)
Operating expenses	6,742	4,176	3,650
Other income (exp)	824	(788)	(178)
Net income	\$3,068	\$5,922	(\$4,966)

Topic: Constructing a balance sheet**LO: 1**

4. Compute the missing amounts for each of the last 3 years for West Suburban Inc.

(millions)	2016	2015	2014
Current assets	\$13,360		\$12,006
Noncurrent assets	6,760	7,612	
Total assets		19,038	17,632
Current liabilities	5,422	5,278	4,864
Noncurrent liabilities	3,564		6,728
Total liabilities	8,986	10,078	
Stockholders' equity		8,960	6,040
Liabilities and equity			

Answer:

	2016	2015	2014
Current assets	\$13,630	\$ 11,426	\$12,006
Noncurrent assets	<u>6,760</u>	<u>7,612</u>	<u>5,626</u>
Total assets	<u>\$20,390</u>	<u>\$19,038</u>	<u>\$17,632</u>
Current liabilities	\$5,422	\$5,278	\$4,864
Noncurrent liabilities	<u>3,564</u>	<u>4,800</u>	<u>6,728</u>
Total liabilities	8,986	10,078	<u>11,592</u>
Stockholders' equity	<u>11,404</u>	<u>8,960</u>	<u>6,040</u>
Liabilities and equity	<u>\$20,390</u>	<u>\$19,038</u>	<u>\$17,632</u>

Topic: Transaction analysis

LO: 2, 4, 6

5. Identify the effects of the following transactions in the table below:

Transaction	Balance Sheet							Income Statement						
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
(1) \$600 of employee wages are earned but not yet paid				=									=	
(2) \$3,000 of inventory is purchased on credit				=									=	
(3) Sold goods for \$1,500 on account				=									=	
(4) Record \$700 for the cost of inventory sold in (3) above				=									=	
(5) Collected \$1,000 cash from transaction (3) above				=									=	
(6) \$3,000 of equipment is acquired for cash				=									=	
(7)Paid \$12,000 on a note payable that came due				=									=	
(8) Paid \$600 cash interest on borrowings				=									=	

Answer:

Balance Sheet									Income Statement					
Transaction	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	Revenues	-	Expenses	=	Net Income
(1) \$600 of employee wages are earned but not yet paid				=	+600 Wages Payable				-600 Retained Earnings			+600 Wages Expense	=	-600
(2) \$3,000 of inventory is purchased on credit			+3,000 Inventory	=	+3,000 Accounts Payable								=	
(3) Sold goods for \$1,500 on account			+1,500 Accounts Receivable	=					+1,500 Retained Earnings	+1,500 Sales Revenue			=	+1,500
(4) Record \$700 for the cost of inventory sold in (3) above			-700 Inventory	=					-700 Retained Earnings			+700 Cost of Goods Sold	=	-700
(5) Collected \$1,000 cash from transaction (3) above	+1,000 Cash		-1,000 Accounts Receivable	=									=	
(6) \$3,000 of equipment is acquired for cash	-3,000 Cash		+3,000 Equipment	=									=	
(7) Paid \$12,000 on a note payable that came due	-12,000 Cash			=	-12,000 Note Payable								=	
(8) Paid \$600 cash interest on borrowings	-600 Cash			=					-600 Retained Earnings			+600 Interest Expense	=	-600

Topic: Transaction analysis

LO: 2, 4, 6

6. Identify the effects of the following transactions in the table below:

Transaction	Balance Sheet						Income Statement			
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	
(1) Signed a note payable and received \$4,000 cash				=						=
(2) Purchased inventory for \$3,000 on credit				=						=
(3) Sold goods for \$3,500 on account				=						=
(4) Recorded \$900 for the cost of merchandise sold in (3) above				=						=
(5) Collected \$2,200 cash from transaction (3) above				=						=
(6) Paid \$600 on the account payable in transaction (2) above				=						=
(7) Employees earn \$900 in wages to be paid the following month				=						=
(8) Sold gift cards for \$300 cash				=						=

Answer:

Transaction	Balance Sheet						Income Statement			
	Cash Asset	+	Noncash Assets	=	Liabilities	+	Contrib. Capital	+	Earned Capital	
(1) Signed a note payable and received \$4,000 cash	+4,000 Cash			=	+4,000 Notes Payable					=
(2) Purchased inventory for \$3,000 on credit			+3,000 Inventory	=	+3,000 Accounts Payable					=
(3) Sold goods for \$3,500 on account			+3,500 Accounts Receivable	=				+3,500 Retained Earnings	+3,500 Sales Revenue	=
(4) Recorded \$900 for the cost of merchandise sold in (3) above			-900 Inventory	=			-900 Retained Earnings		+900 Cost of Goods Sold	-900
(5) Collected \$2,200 cash from transaction (3) above	+2,200 Cash		-2,200 Accounts Receivable	=						=
(6) Paid \$600 on the account payable in transaction (2) above	-600 Cash			=	-600 Accounts Payable					=
(7) Employees earn \$900 in wages to be paid the following month				=	+900 Wages Payable			-900 Retained Earnings	+900 Wage Expense	-900
(8) Sold gift cards for \$300 cash	+300 Cash			=	+300 Unearned Revenue					=

Essays

Topic: Historical cost vs. Market value

LO: 1

1. With few exceptions, why do we report most assets at their original acquisition price (historical cost) and not at current market value?

Answer:

When company valuation is the goal, accurate and current market values of assets are preferred. For some assets like marketable securities, values are readily obtained from online quotes. For other assets like property, plant and equipment, we can only estimate their market values until they are ultimately sold. Allowing companies to report estimates of market values for assets would introduce potential bias into financial reporting, thus lessening financial statement reliability and usefulness.

Topic: Intangible assets vs. Tangible assets

LO: 1

2. Compare and contrast intangible and tangible assets.

Answer:

Intangible assets are similar to property, plant and equipment (PP&E) in that they are owned and controlled by the company and the company expects to realize future benefits from the use of the asset. For example, an internally created intangible asset, such as Mickey Mouse in the case of Walt Disney, is owned and controlled by Walt Disney and the company certainly anticipates that it will generate future sales from Mickey Mouse.

Despite these similarities, Mickey Mouse cannot be capitalized because its historical cost is not reliably measurable. In contrast, the historical cost of PP&E is reliably measurable, and, therefore, can be capitalized on the balance sheet.

Topic: Undervalued assets

LO: 1

3. Prepare a list of two possible undervalued assets on the balance sheet of a company. Indicate how these items can be undervalued.

Answer:

Land is an asset that can often be undervalued on a balance sheet because it is typically an appreciating asset. Inventories are often carried at cost, below their current market price if prices rise since the items were acquired.