

Test Questions and Solutions

Chapter 1

True-False

1. A basic understanding of financial statements is needed due to ongoing financial turmoil and major corporate failures.
2. The SEC requires all companies, both public and private, to file annually a Form 10-K report.
3. Financial statements are currently prepared according to generally accepted accounting principles in the U.S.
4. The FASB was given Congressional authority to write accounting rules.
5. The goal of the International Accounting Standards Board is the adoption of uniform international accounting standards.
6. In 2006, the IASB and the FASB agreed to work on all major projects jointly.
7. Annual reports of public companies can only be found on the SEC's EDGAR database.
8. A corporate annual report contains three basic financial statements.
9. The notes to financial statements, while helpful, are not an integral part of the statements.
10. Management is responsible for the preparation of the financial statements, including the notes, and the auditor's report attests to the fairness of the presentation.
11. The Sarbanes-Oxley Act eliminated the need for internal auditors.
12. An unqualified auditor's report states that the financial statements present fairly the financial position, results of operation, and the cash flows of the entity.

13. The Sarbanes-Oxley Act of 2002 requires all members of management as well as directors to certify the accuracy of the financial statements.
14. Despite the enactment of the Sarbanes-Oxley Act of 2002, corruption and unethical behavior continued in the 2000s.
15. The management discussion and analysis is of potential interest to the analyst because it contains information that cannot be found in the financial data.
16. The management discussion and analysis should contain a discussion of the commitments for capital expenditures, the purpose of such commitments, and expected sources of funding.
17. The shareholders' letter from the CEO of a firm offers factual information needed to analyze the financial statements.
18. The proxy statement offers information about such items as corporate governance, audit-related matters, directors and executive compensation, and related party transactions.
19. Publicity in the media can impact a firm's financial performance.
20. Conglomerates operating in diversified lines of business are required to create separate annual reports for each line of business.
21. Accounting choices and estimates rarely have a significant impact on financial statement numbers.
22. The accrual basis of accounting means that revenues are recognized when the sale is made rather than when cash is received.
23. United States accounting rules have been perceived as being less complex than international standards.
24. The matching principle requires that expenses be matched with the generation of revenues in order to determine net income for an accounting period.
25. Examples of discretionary items include repairs and maintenance, research and development and advertising.

Multiple Choice

1. Which report is not required to be filed by public companies to the SEC?
 - a. Annual reports (Form 10-K).
 - b. Financial Reporting Rulings.
 - c. A prospectus for any new security offering.
 - d. Quarterly reports (Form 10-Q).
2. The globalization of business activity has resulted in which of the following?
 - a. Increased corruption and unethical behavior.
 - b. A uniform set of accounting rules in all countries.
 - c. The FASB and IASB working jointly on a project to converge accounting standards.
 - d. The requirement that U.S. firms use international accounting rules as of 2006.
3. What basic financial statements can be found in a corporate annual report?
 - a. Balance sheet, income statement, statement of shareholders' equity, and statement of cash flows.
 - b. Balance sheet, auditor's report and income statement.
 - c. Earnings statement and statement of retained earnings.
 - d. Statement of cash flows and five-year summary of key financial data.
4. What information can be found on a balance sheet?
 - a. Information to support that assets equal liabilities.
 - b. The profit or loss for the accounting period.
 - c. The reasons for changes in the cash account.
 - d. The financial position on a particular date; i.e. assets, liabilities and shareholders' equity.
5. What information can be found on an income statement?
 - a. The financing and investing activities during an accounting period.
 - b. Cash inflows and cash outflows.
 - c. A reconciliation of the beginning and ending balances of all revenue accounts.
 - d. Revenues, expenditures, net profit or loss and net profit or loss per share.

6. What information can be found on a statement of stockholders' equity?
 - a. A reconciliation of the cash account and the retained earnings account.
 - b. A reconciliation of the beginning and ending balances of all accounts that appear in the stockholders' equity section of the balance sheet.
 - c. A reconciliation of the operating, investing and financing activities of a firm.
 - d. A reconciliation of net profit or loss and the cash account.
7. What item is not included in the notes to the financial statements?
 - a. Details about inventory and property, plant and equipment.
 - b. Information about major acquisitions or divestitures.
 - c. The management discussion and analysis.
 - d. A summary of the firm's accounting policies.
8. What type of audit report indicates that the financial statements have not been presented fairly?
 - a. A disclaimer of opinion.
 - b. An unqualified report.
 - c. A qualified report.
 - d. An adverse opinion.
9. What type of audit report indicates that the financial statements have been presented fairly?
 - a. An unqualified report.
 - b. A disclaimer of opinion.
 - c. A qualified report.
 - d. An adverse opinion.
10. What does Section 404 of the Sarbanes-Oxley Act of 2002 require?
 - a. The external auditors must create an adequate internal control structure for the firm being audited.
 - b. The external auditors must approve of all internal auditors hired by a firm.
 - c. The inclusion of an internal control report in the annual report.
 - d. The external auditors need to perform internal audit services.
11. Why does the management discussion and analysis help the analyst?
 - a. It contains information that cannot be found in the financial data.
 - b. It provides predictions of all future financial statement numbers.
 - c. It outlines the accounting choices made by the firm.
 - d. It explains the market valuation of the firm's stock.

12. Which of the following items would not be discussed in the management discussion and analysis?
- a. Commitments for capital expenditures.
 - b. The market value of all assets.
 - c. The internal and external sources of liquidity.
 - d. A breakdown of sales increases into price and volume components.
13. What item is probably the least useful when analyzing financial statements?
- a. Management discussion and analysis.
 - b. The notes to the financial statements.
 - c. The statement of cash flows.
 - d. Public relations materials.
14. What document is required by the SEC to solicit shareholder votes?
- a. Proxy statement.
 - b. Five-year summary.
 - c. Shareholders' letter.
 - d. Prospectus.
15. What types of information cannot be found in the financial statements?
- a. Details about officer and employee retirement, pension, and stock option plans.
 - b. Pending legal proceedings.
 - c. Reputation of the firm, morale of employees and prestige in the community.
 - d. Disclosures about segments of an enterprise.
16. How are revenues and expenses recognized under the accrual basis of accounting?
- a. Revenues are recognized when cash is received and expenses are recognized when cash is paid.
 - b. Revenues and expenses are recognized equally over a twelve month period.
 - c. Revenues and expenses are recognized based on the choices of management.
 - d. Revenues are recognized in the accounting period when the sale is made and expenses are recognized in the period in which they relate to the sale of the product.

17. Which of the following statements is true?
- a. GAAP-based financial statements are prepared according to the “cash” rather than the “accrual” basis of accounting.
 - b. Accounting choices and estimates can have a significant impact on the outcome of financial statement numbers.
 - c. The accrual method means that the expense is recognized after the cash is paid out.
 - d. The purpose of the accrual method is to attempt to “match” assets with liabilities in appropriate accounting periods.
18. In what industries would it be expected that companies would spend a significant amount on research and development activities?
- a. Health.
 - b. Clothes retailer.
 - c. Auto.
 - d. Both (a) and (c).
19. Which of the following items is NOT discretionary in nature?
- a. Union wages.
 - b. Repairs and maintenance.
 - c. Research and development.
 - d. Advertising.
20. Which of the following could be detrimental to a firm’s sales and earnings?
- a. Using the matching principle when recording revenues and expenses.
 - b. Deferring repairs and maintenance on equipment.
 - c. Investing in research and development.
 - d. Increasing discretionary expenses.

For each of the following items indicate where you would most likely find the information.

- a. Balance sheet.
- b. Income statement.
- c. Statement of stockholders' equity.
- d. Statement of cash flows.
- e. Notes to the financial statements.
- f. Auditor's report.
- g. Management's discussion and analysis.

21. Revenues.
22. Detailed information about the term, cost and maturity of debt.
23. Changes to the company's equity accounts.
24. An unqualified opinion.
25. Assets.
26. Attestation to the fairness of financial statements.
27. Discussion of the company's liquidity.
28. Cash inflows from investing activities.
29. A breakdown of sales increases into price and volume components.
30. Summary of significant accounting policies.

Short Answer

1. Write a short essay explaining the importance of financial statements and their accompanying notes.
2. List and describe the four basic financial statements included in a corporate annual report.
3. Discuss the similarities and differences between a company's Form 10-K and an annual report created especially to send to the stockholders.
4. Explain the importance of reading the notes to the financial statements.
5. Discuss the role of the SEC, the FASB, and the IASB.
6. Define the following terms related to the auditor's report: unqualified, qualified, adverse, and disclaimer of opinion.
7. According to the textbook "Internal auditors have become the 'rock stars' of the accounting industry." Explain what this means.

8. How did the Sarbanes-Oxley Act of 2002 change the regulatory model for auditors?
9. Explain how Congress addressed the issue of auditor independence in the Sarbanes-Oxley Act of 2002.
10. What regulations were included as part of the Sarbanes-Oxley Act of 2002 that should encourage CEOs and CFOs to act ethically?
11. Explain what types of information can be learned from the management discussion and analysis about liquidity? capital resources? operations?
12. What types of information are necessary to evaluate a company but cannot be found in the financial statements?
13. How can management affect the quality of financial statements?
14. What are discretionary items and why are they important to the operating success of a firm?

Solutions - Chapter 1

True-False

- | | | | | |
|------|-------|-------|-------|-------|
| 1. T | 6. T | 11. F | 16. T | 21. F |
| 2. F | 7. F | 12. T | 17. F | 22. T |
| 3. T | 8. F | 13. F | 18. T | 23. F |
| 4. F | 9. F | 14. T | 19. T | 24. T |
| 5. T | 10. T | 15. T | 20. F | 25. T |

Multiple Choice

- | | | | | | |
|------|-------|-------|-------|-------|-------|
| 1. b | 6. b | 11. a | 16. d | 21. b | 26. f |
| 2. c | 7. c | 12. b | 17. b | 22. e | 27. g |
| 3. a | 8. d | 13. d | 18. d | 23. c | 28. d |
| 4. d | 9. a | 14. a | 19. a | 24. f | 29. g |
| 5. d | 10. c | 15. c | 20. b | 25. a | 30. e |

Short Answer

1. Financial statements and their accompanying notes contain a wealth of useful information regarding the financial position of a company, the success of its operations, the policies and strategies of management, and insight into its future performance. The objective of the financial statement user is to find and interpret this information to answer questions about the company, such as the following:

- Would an investment generate attractive returns?
- What is the degree of risk inherent in the investment?
- Should existing investment holdings be liquidated?
- Will cash flows be sufficient to service interest and principal payments to support the firm's borrowing needs?
- Does the company provide a good opportunity for employment, future advancement, and employee benefits?
- How well does this company compete in its operating environment?
- Is this firm a good prospect as a customer?

2. The balance sheet shows the financial position—assets, liabilities, and stockholders' equity—of the firm on a particular date, such as the end of a quarter or a year.

The income statement presents the results of operations—revenues, expenses, net profit or loss and net profit or loss per share—for the accounting period.

The statement of shareholders' equity reconciles the beginning and ending balances of all accounts that appear in the shareholders' equity section of the balance sheet.

The statement of cash flows provides information about the cash inflows and outflows from operating, investing, and financing activities during an accounting period.

3. The annual report and the Form 10-K generally include the company's four financial statements, notes to the financial statements and other items such as the management's discussion and analysis, auditor's report, five-year summary of selected financial data and market data. The annual report may contain public relations material that the Form 10-K does not, such as colored photographs, charts and, a letter to the shareholders from the CEO. The Form 10-K presents information in a specific order as required by the SEC that may not be included in an annual report created separately.

4. The notes to the financial statements are an integral part of the financial statements and must be read to thoroughly understand the statements. The notes include important information such as a summary of the firm's accounting policies and any changes to those policies during the reporting period, details about particular asset, liability, and equity accounts, major acquisitions or divestitures, officer and employee retirement, pension and stock option plans, leasing arrangements, the term, cost, and maturity of debt, pending legal proceedings, income taxes, contingencies and commitments, quarterly results of operations, and operating segments.

5. The SEC regulates U. S. companies that issue securities to the public and requires the issuance of a prospectus for any new security offering. The SEC also requires regular filing of annual reports, quarterly reports and other reports depending on particular circumstances. Congress has given the SEC authority to set accounting policies, although the SEC has largely delegated the role of rulemaking to the FASB.

The FASB is a private sector organization. The board issues rules and interpretations of those rules after a lengthy deliberation process. The board has no authority to enforce its rules, however, the SEC and FASB work closely and the SEC has generally enforced the rules that the FASB writes.

The role of the IASB is to work toward creating a set of international generally accepted accounting principles that will have worldwide acceptance in our global society. This would allow companies to list securities in any market without having to prepare multiple sets of financial statements.

6. An unqualified report states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows for the accounting period, in conformity with GAAP. A qualified report reveals a departure from GAAP. An adverse opinion is rendered when the departure from GAAP affects numerous accounts and financial statements so that the financial statements have not been presented fairly in accordance with GAAP. A disclaimer of opinion means the auditor cannot evaluate the fairness of the financial statements and therefore expresses no opinion on them.

7. Internal auditors have become the "rock stars" of the accounting industry as a result of the Sarbanes-Oxley Act of 2002 (SOX). Section 404 of the act requires companies to include in their annual reports a statement regarding the effectiveness of internal controls and the disclosure of any material weaknesses in a firm's internal controls system. This requirement has greatly boosted the need for internal auditors and SOX compliance specialists, but more importantly, has enhanced the value of the internal audit function within companies, as businesses have strengthened internal controls in response to SOX.

8. Prior to the passage of the Sarbanes-Oxley Act of 2002, auditors followed a self-regulatory model. Title I of the act established the Public Company Accounting Oversight Board (PCAOB), a private, nonprofit organization, which has been given the authority to register, inspect, and discipline auditors of all publicly owned companies; however, the SEC appoints the board members and has ultimate oversight of the PCAOB. In addition, the PCAOB now has the authority to write auditing rules, quality control and ethics standards.

9. Title II of the Sarbanes-Oxley Act of 2002 addresses the area of auditor independence, prohibiting audit firms from providing certain nonaudit services when conducting an external audit of a firm. Prohibited services include bookkeeping, design and implementation of financial information systems,

valuation and appraisal services, actuarial services, internal audit services, management or human resource functions, and broker, dealer, or investment banking services. Title II also encourages auditor independence by requiring the rotation of audit partners every five years if the audit partner is the primary partner responsible for a particular audit client. Another issue relating to auditor independence occurs when a company hires its chief financial officer (CFO) or other finance personnel from the ranks of the external audit firm. Section 206 of Title II inserts a one-year waiting period before an employee from the external audit firm may go to work for a client in the position of CEO, CFO, controller or any equivalent executive officer position, any financial oversight role and any person preparing financial statements.

10. Titles III and IV of the Sarbanes-Oxley Act of 2002 focus on corporate responsibility while Title IX attaches harsher penalties for violations. Section 302 requires that the chief executive officer and the chief financial officer of a publicly owned company certify the accuracy of the financial statements. An officer who certifies a report that is later found to be inaccurate could face up to \$1 million in fines and/or a jail sentence of up to 10 years according to Section 906. These two sections work in conjunction with Section 404 (discussed previously) to encourage CEOs and CFOs to take responsibility for strong internal controls to prevent accounting fraud and financial statement misrepresentation.

11. The management discussion and analysis includes a discussion of the favorable and unfavorable trends and significant events or uncertainties in the areas of liquidity, capital resources, and results of operations. With regard to liquidity the analyst can expect to find a discussion of the internal and external sources of liquidity and any material deficiencies in liquidity and how they will be remedied. The discussion of capital resources should include commitments for capital expenditures, the purpose of such commitments, and expected funding sources, as well as anticipated changes in the mix and cost of financing resources. Information about the results of operations should include unusual or infrequent transactions that affect income from continuing operations, events that cause material changes in the relationship between costs and revenues, and a breakdown of sales increases into price and volume components.

12. Some of the items needed to evaluate a company that are missing from the financial statements are intangibles such as employee relations with management, morale and efficiency of employees, the reputation of the firm with its customers, its prestige in the community, the effectiveness of management, provisions for management succession, and potential exposure to changes in regulations such as

environmental or food and drug enforcement. Publicity in the media also affects the public perception of the firm and can impact the financial performance of the company.

13. Management has considerable discretion within the overall framework of GAAP, allowing for the potential manipulation of the financial statement numbers. The potential exists for management to manipulate the bottom line and other accounts in the financial statements. Although accounting rules provide guidelines helpful in making accounting allocations, these rules are not always precise. The timing of revenue and expense recognition can be based on arbitrary managerial decisions. Management may choose to cut costs in critical areas such as repairs and maintenance, research and development, advertising, and capital expansion with the sole purpose of increasing the bottom line, but at the expense of long-term profitability in the firm.

14. Discretionary expenses are those items that management exercises control with regard to the budget level and timing of the expenditures. Examples of discretionary expenses include repair and maintenance of machinery and equipment, marketing and advertising, research and development, and capital expansion. Each choice regarding these discretionary items has both an immediate and a long-term impact on profitability, perhaps not in the same direction. A company might elect to defer plant maintenance in order to boost current period earnings; ultimately, the effect of such a policy could be detrimental. For some industries, such as beverages and retail marketing, advertising and marketing expenditures are essential to gaining and maintaining market share. Research and development can be critical for ongoing success of industries such as computing and electronics, health and auto.

The financial analyst should carefully scrutinize management's policies with respect to these discretionary items through an examination of expenditure trends (absolute and relative amounts) and comparison with industry competitors. Such an analysis can provide insight into a company's existing strengths and weaknesses and contribute to an assessment of its ability to perform successfully in the future.

Chapter 2

True-False

1. The balance sheet shows the financial position of a company n a particular date.
2. Consolidated statements are the combined financial statements of separate legal entities when the parent controls 100% of the subsidiary.
3. A common size balance sheet expresses each item on the balance sheet as a percentage of either total assets or total liabilities.
4. Current assets include those assets expected to be converted into cash within one year or operating cycle.
5. Marketable securities should be valued at fair market value.
6. Marketable securities are also referred to as short-term investments.
7. Accounts receivable are balances owed to suppliers.
8. When analyzing accounts receivable and the allowance for doubtful accounts it is helpful to assess the relationship between the growth rates of sales, accounts receivable, and the allowance for doubtful accounts.
9. A decline in accounts receivable when sales are increasing is a red flag that the firm is not collecting cash from its customers.
10. Inventory valuation is based on an assumption regarding the flow of goods and has nothing to do with the actual order in which products are sold.
11. Using FIFO during a period of inflation would result in net income being overstated relative to the LIFO method.
12. The straight-line depreciation method allocates an equal amount of depreciation expense to each year of the depreciation period.
13. Most manufacturing firms use the accelerated depreciation method while retailers use the straight-line depreciation method for financial reporting purposes.

14. Goodwill arises when one company acquires another company for a price in excess of the fair market value of the net identifiable assets acquired.
15. Accounts payable are short-term obligations that arise from credit extended by suppliers for the purchase of goods and services.
16. Accrued liabilities are a result of paying for an expense prior to the recognition of the expense.
17. Companies that are paid in advance for services or products record a liability on the receipt of cash referred to as unearned revenue or deferred credits.
18. Temporary differences are a result of recording revenues or expenses on financial statements in an accounting period different from when these items are recorded on the firm's tax return.
19. A deferred tax asset is recorded when expenses are recorded on the income statement but not allowed to be deducted for tax purposes until a later accounting period.
20. A capital lease affects only the income statement.
21. The commitments and contingencies account listed on a balance sheet is meant to draw attention to the fact that required disclosures can be found in the notes to the financial statements.
22. Contingencies refer to the amounts owed by companies to settle lawsuits.
23. The retained earnings account is increased (decreased) by net income (loss) and increased by dividends each year.
24. The retained earnings account is the sum of every dollar a company has earned since its inception, less any payments made to shareholders in the form of cash or stock dividends.
25. Items related to the quality of financial reporting on the balance sheet, such as off-balance-sheet financing, should be assessed when analyzing this financial statement.

Multiple Choice

1. Which item below does not describe a balance sheet?
 - a. $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$.
 - b. Financial position at a point in time.
 - c. $\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}$.
 - d. $\text{Assets} + \text{Liabilities} = \text{Stockholders' Equity}$.
2. Which of the following statements is false?
 - a. Annual reports must include three-year audited balance sheets and two-year audited income statements.
 - b. The balance sheet is prepared on a particular date.
 - c. Interim statements are generally prepared quarterly.
 - d. When a parent company owns more than 50% of the voting stock of a subsidiary, the financial statements are consolidated for both entities.
3. Which of the following statements about a common-size balance sheet is true?
 - a. Each item on a common-size balance sheet is expressed as a percentage of sales.
 - b. The common-size balance sheet reveals the composition of expenses relative to revenues.
 - c. The common-size balance sheet reveals the capital and debt structure of the firm.
 - d. Each item on a common-size balance sheet is expressed as a percentage of net income.
4. What are current assets?
 - a. Assets purchased within the last year.
 - b. Assets which will be used within the next month.
 - c. Assets are the net working capital of the firm.
 - d. Assets expected to be converted into cash within one year or operating cycle.
5. How are marketable securities valued on the balance sheet?
 - a. Historical cost.
 - b. At cost or fair value depending on how the securities are classified.
 - c. Market value.
 - d. At fair value with the difference between cost and fair value reported as revenue.

6. What does the term “net realizable value” mean with regard to the accounts receivable account?
- a. The gross amounts owed by customers for credit purchases.
 - b. Total accounts receivable plus an amount estimated for bad debts.
 - c. The allowance for doubtful accounts less bad debt expense.
 - d. Actual amounts of accounts receivable less an allowance for doubtful accounts.
7. Which of the following items would not be considered when analyzing accounts receivable and allowance for doubtful accounts?
- a. The relationship among changes in sales, accounts receivable and the allowance for doubtful accounts.
 - b. A comparison of actual write-offs relative to amounts recognized as bad debts.
 - c. The relationship between accounts receivable, inventory , and accounts payable.
 - d. An analysis of the “Valuation and Qualifying Accounts” schedule required in the Form 10-K.
8. The inventory of a retail company is comparable to which type of inventory of a manufacturing company?
- a. Finished goods.
 - b. Work in process.
 - c. Supplies.
 - d. Raw materials.
9. Which type of firm would carry little or no inventory?
- a. A manufacturing firm.
 - b. A retail firm.
 - c. A service firm.
 - d. A wholesale firm.
10. If a company chooses the LIFO method of inventory valuation, which inventory will appear as ending inventory on the balance sheet?
- a. The last inventory purchased.
 - b. The first inventory purchased.
 - c. An average of all inventory purchased.
 - d. The actual inventory which has not been sold.

Assume the following purchases of inventory for ABC Company and use this information to answer questions 11 through 13:

<u>Purchase #</u>	<u>Purchase Price</u>
1	\$3
2	\$4
3	\$5
4	\$6
5	\$7

11. Assume ABC sells two items and uses the FIFO method of inventory valuation. What amount would appear in ending inventory on the balance sheet?

- a. \$7
- b. \$15
- c. \$18
- d. \$25

12. Assume ABC sells three items and uses the LIFO method of inventory valuation. What amount would appear for cost of goods sold on the income statement?

- a. \$18
- b. \$12
- c. \$15
- d. \$25

13. Assume ABC uses the average cost method of inventory valuation. What unit cost would be used to determine the amount in ending inventory or cost of goods sold?

- a. \$3
- b. \$5
- c. \$7
- d. \$25

14. Which of the following statements is true?

- a. Land should be depreciated over the period of time it benefits the firm.
- b. Accelerated depreciation must be used for financial reporting purposes.
- c. Fixed assets are reported at historical cost plus accumulated depreciation.
- d. The total amount of depreciation over the asset's life is the same regardless of depreciation method, although the rate of depreciation varies.

15. Which of the following statements is false?
- a. Goodwill arises when one company acquires another company for a price in excess of the fair market value of the net identifiable assets acquired.
 - b. Goodwill should be depreciated.
 - c. Goodwill must be evaluated annually to determine if there has been a loss of value.
 - d. If the carrying value of goodwill exceeds the fair value, the excess book value must be written off as an impairment expense.
16. Which of the following would cause the recognition of a liability?
- a. Credit extended by suppliers.
 - b. Receipt of cash in advance for services.
 - c. Recognition of expense prior to the actual payment of cash.
 - d. All of the above.
17. Which items would be classified as liabilities?
- a. Accounts payable, unearned revenue, pension liabilities.
 - b. Common stock, retained earnings, bonds payable.
 - c. Commitments and contingencies, additional paid-in capital, notes payable.
 - d. Deferred taxes, accrued expenses, treasury stock.
18. What causes the creation of a deferred tax account on the balance sheet?
- a. Permanent differences in income tax accounting.
 - b. The use of the straight-line method of depreciation for both reporting and tax purposes.
 - c. Temporary differences in the recognition of revenue and expense for taxable income relative to reported income.
 - d. Municipal bond revenue and life insurance premiums on officers.
19. Which statement best describes the retained earnings account?
- a. The retained earnings account is equal to the cash account less dividends paid.
 - b. Retained earnings are funds a company has chosen to reinvest in the operations of a business rather than pay out to stockholders in dividends.
 - c. Retained earnings represent unused cash of the firm.
 - d. The retained earnings account is the measurement of all distributed earnings.

20. Which item would be included in the account "Accumulated other comprehensive income (expense)"?

- a. Treasury stock.
- b. Preferred stock.
- c. Foreign currency translation adjustments.
- d. Additional paid-in capital.

How would each of the following items be classified on the balance sheet?

- a. Current assets.
- b. Long-term assets.
- c. Current liabilities.
- d. Long-term liabilities.
- e. Stockholders' equity.

21. Accounts payable.

22. Inventory.

23. Additional paid-in capital.

24. Bonds payable.

25. Equipment.

26. Marketable securities.

27. Current maturities of long-term debt.

28. Retained earnings.

29. Accounts receivable.

30. Accumulated depreciation.

Short Answer/Problem

1. What is the balancing equation? Explain each of the components of the equation and give examples of each component.

2. Using the following information analyze the accounts receivable and the allowance for doubtful accounts for this company:

	<u>2011</u>	<u>2010</u>
Sales	\$6,700	\$7,500
Accounts receivable, net	202	320
Allowance for doubtful accounts	3	12

3. The following calculations have been made for Coos Company:

	<u>Growth Rate</u>
Net sales	10.5%
Total accounts receivable	21.3%
Allowance for doubtful accounts	2.6%

	<u>Current Year</u>	<u>Prior Year</u>
Allowance for doubtful accounts as a percentage of total accounts receivable	3.8%	5.4%

- Analyze the accounts receivable and allowance for doubtful accounts.
- What other information would be useful for the analysis completed in part a?

4. Using the following excerpts from the most recent annual report of Health Supplements, Inc., a leading manufacturer of nutritional supplements, analyze the accounts receivable and allowance for doubtful accounts. Be sure to show all calculations and write a thorough interpretation of those calculations.

<i>(dollars in thousands)</i>	<i>2011</i>	<i>2010</i>
Net sales	\$97,128	\$99,612
Accounts receivable - less allowance for doubtful accounts of \$20 at June 30, 2011 and \$217 June 30, 2010	\$ 5,264	\$12,839

Concentrations of Credit Risk

Credit risk with respect to receivables is concentrated with our three largest customers, whose receivable balances collectively represented 75% of gross accounts receivable at June 30, 2011 and 79% at June 30, 2010. Concentrations of credit risk related to the remaining accounts receivable balances are limited due to the number of customers comprising our remaining customer base.

Health Supplements, Inc.
Valuation And Qualifying Accounts
For the Years Ended June 30, 2011, 2010 and 2009

	Balance at beginning of period	Charged to expenses	Deductions	Balance at end of period
Allowance for doubtful accounts				
2011	\$217	(\$41)	(\$156)	\$20
2010	\$221	\$57	(\$61)	\$217
2009	\$132	\$101	(\$12)	\$221

5. a. Explain how inventory is valued if the FIFO method is used.
 - b. Explain how inventory is valued if the LIFO method is used.
 - c. Why would a manager choose the FIFO method during an inflationary period?
 - d. Why would a manager choose the LIFO method during an inflationary period?
6. If a firm chooses to use the FIFO method of inventory valuation instead of the LIFO method, explain the impact of deflation on the amounts shown on the balance sheet for inventory and on the income statement for cost of goods sold.
7. Using the following information calculate the ending inventory balance and the cost of goods sold expense that would be reported at the end of the year if the following inventory valuation methods are used:
- a. FIFO
 - b. LIFO
 - c. Average cost

	<u>Units</u>	<u>Purchase Price</u>
Beginning inventory	8	\$5
Purchase #1	10	\$6
Purchase #2	14	\$7
Purchase #3	12	\$6
Sales	40	

8. Using the following information calculate the ending inventory balance and the cost of goods sold expense that would be reported at the end of the year if the following inventory valuation methods are used:

- a. FIFO
- b. LIFO
- c. Average cost

	<u>Units</u>	<u>Purchase Price</u>
Beginning inventory	20	\$12
Purchase #1	100	\$11
Purchase #2	85	\$10
Purchase #3	90	\$ 9
Sales	235	

9. The Presto Company purchases equipment for \$20,000. Management estimates that the equipment will have a useful life of five years and no salvage value.

- a. Calculate depreciation expense and the book value of the equipment at the end of the first year using the straight-line method of depreciation.
- b. Calculate depreciation expense and the book value at the end of the first year using the double-declining balance method of depreciation.

10. Brown Co. purchased a piece of equipment last year for \$500,000. Management estimates that the equipment will have a useful life of five years and no salvage value. The depreciation expense recorded for tax purposes will be \$120,000 this year (Year 2). The company uses the straight-line method of depreciation for reporting purposes.

- a. Calculate the amount of depreciation expense for reporting purposes this year (Year 2).
- b. What will be the net book value of the equipment reported on the balance sheet at the end of this year (Year 2)?
- c. Will a deferred tax asset or liability be created as a result of the depreciation recorded for tax and financial reporting purposes?
- d. What amount will be added to the deferred tax account as a result of the depreciation timing difference?

11. InDebt Corporation has a \$200,000 note outstanding with a 10% annual rate of interest due in semiannual installments on March 31 and September 30. What amount will be shown as accrued interest on a December 31 balance sheet?

12. Hoffman's Hotel has total revenue of \$900,000; expenses other than depreciation of \$400,000; depreciation expense for tax purposes of \$250,000; and depreciation expense of \$180,000 for reporting purposes. The tax rate is 35%. Calculate net income for reporting purposes and tax purposes and also calculate the deferred tax liability.

13. Write a short essay explaining the difference between an operating and a capital lease.

14. Explain why the account titles "Commitments and Contingencies" appears on a balance sheet without a corresponding dollar amount.

15. Brian's Building Company reported the following amounts on their financial statements this year:

Total assets	\$56,000
Total liabilities	\$32,000
Net income	\$ 7,500
Beginning retained earnings	\$ 9,800
Ending retained earnings	\$10,400

a. Calculate total stockholders' equity.

b. Calculate the amount of dividends that were most likely paid this year.

16. StoreMart had the following balancing equation at the end of last year:

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

$$\$100,000 = \$65,000 + \$35,000$$

During the year StoreMart increased assets by \$20,000 and added debt in the amount of \$7,000. The only stockholders' equity account that changed was retained earnings. If no dividends were paid, how much net income was generated this year?

17. Using the information below for Jumbo Corporation, calculate the amount of dividends Jumbo most likely paid to common stockholders in 2010, 2011, and 2012.

Retained earnings balances		Net income	
January 1, 2010	\$500		
December 31, 2010	\$760	2010	\$450
December 31, 2011	\$875	2011	\$325
December 31, 2012	\$950	2012	\$240

18. Why would a firm repurchase their own shares of common stock?

19. The following list of balance sheet accounts with corresponding amounts is available for Green Co. at the end of the year. Classify the accounts using the following headings: current assets, long-term assets, current liabilities, long-term liabilities, and stockholders' equity. (Hint: You can check your answer using the balance sheet equation.)

Accounts payable	29	Cash	25
Short-term investments	22	Common stock	1
Deferred taxes, current	6	Treasury stock	(4)
Property & Equip., net	67	Prepaid expenses	3
Accounts receivable	11	Inventories	13
Long-term debt	20	Add'l. paid-in capital	51
Current portion of long-term debt	5	Retained earnings	45

20. Using the following balance sheet, prepare a common size balance sheet:

<u>Assets</u>		<u>Liabilities and stockholders' equity</u>	
Current assets		Current liabilities	
Cash	5	Accounts payable	29
Short-term investments	15	Current portion of	
Accounts receivable	21	long-term debt	<u>9</u>
Inventory	23	Total current liabilities	38
Prepaid expenses	3	Long-term liabilities	
Deferred taxes, current	<u>6</u>	Long-term debt	<u>45</u>

Total current assets	73	Total liabilities	83
Long-term assets		Stockholders' equity	
Property & equipment	67	Common stock and PIC	52
Goodwill	13	Retained earnings	
<u>25</u>			
Long-term investments	5		
Other assets	<u>2</u>	Total stockholders' equity	<u>77</u>
Total assets	<u>160</u>	Total liabilities and equity	<u>160</u>

21. Analyze the following common size balance sheet:

	<u>2011</u>	<u>2010</u>
Current assets:		
Cash	3%	5%
Accounts receivable	20	18
Inventory	<u>35</u>	<u>30</u>
Total current assets	58%	53%
Property, plant and equipment	30	40
Other assets	<u>12</u>	<u>7</u>
Total assets	<u>100%</u>	<u>100%</u>
Current liabilities:		
Accounts payable	25%	20%
Short-term debt	<u>38</u>	<u>33</u>
Total current liabilities	63%	53%
Long-term debt	<u>22</u>	<u>17</u>
Total liabilities	85%	70%
Common stock and paid in capital	14	20
Retained earnings	<u>1</u>	<u>10</u>
Total stockholders' equity	<u>15%</u>	<u>30%</u>
Total liabilities and stockholders' equity	<u>100%</u>	<u>100%</u>

Solutions - Chapter 2

True-False

- | | | | | |
|------|-------|-------|-------|-------|
| 1. T | 6. T | 11. T | 16. F | 21. T |
| 2. F | 7. F | 12. T | 17. T | 22. F |
| 3. F | 8. T | 13. F | 18. T | 23. F |
| 4. T | 9. F | 14. T | 19. T | 24. T |
| 5. F | 10. T | 15. T | 20. F | 25. T |

Multiple Choice

- | | | | | | |
|------|-------|-------|-------|-------|-------|
| 1. d | 6. d | 11. c | 16. d | 21. c | 26. a |
| 2. a | 7. c | 12. a | 17. a | 22. a | 27. c |
| 3. c | 8. a | 13. b | 18. c | 23. e | 28. e |
| 4. d | 9. c | 14. d | 19. b | 24. d | 29. a |
| 5. b | 10. b | 15. b | 20. c | 25. b | 30. b |

Short Answer/Problem

1. The balancing equation is: $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$
Assets are items owned and are organized on the balance sheet according to how they are utilized. Current assets are those assets expected to be converted into cash within one year or operating cycle, whichever is longer. Examples include cash, accounts receivable, inventory, and prepaid expenses. Assets not used up in the ebb and flow of annual business operations include property, plant, and equipment, intangible assets, and long-term investments.

Liabilities are what a firm owes to outsiders. Current liabilities are those debts due within one year or operating cycle, whichever is longer and include accounts payable, short-term notes payable, current maturities of long-term debt, accrued liabilities, and unearned revenue. Liabilities due in more than one year include long-term debt, capital lease obligations and pension and postretirement benefits.

Stockholders' equity represents the ownership interests in the company or the residual interest in assets that remains after deducting liabilities. Examples of stockholders' equity accounts include common stock, additional paid-in capital, retained earnings, preferred stock, treasury stock, and accumulated other comprehensive income.

2.	<u>2011</u>	<u>2010</u>
<u>Allowance for doubtful accts.</u>		
Accts. Receivable + Allow.	1.5%	3.6%
Growth rates: Sales	(10.7%)	
Accts. Receivable (net)	(36.9%)(A/R, gross, 38.3%)	
Allowance for doubt. accts.	(75.0%)	

Sales for this company have decreased so it is expected that the accounts receivable and allowance for doubtful accounts would also decrease. Accounts receivable has decreased at a faster rate than sales while the allowance for doubtful accounts has decreased at a faster rate than accounts receivable. The percentage of estimated bad accounts has dropped by more than a percentage point relative to the prior year. Possible explanations for this inconsistency could be:

1. the company has tightened its credit policy,
2. prior bad debt estimates were too high and the company is correcting for this, or
3. management has intentionally reduced bad debts to report a higher net income.

3. Sales, accounts receivable and the allowance for doubtful accounts have all grown, but not proportionately. The allowance account increased only slightly, and as a percentage of total accounts receivable, the allowance account has declined from 5.4% to 3.8%. This is not a normal pattern. Possible explanations are that management overestimated the account in prior years and is now correcting for that overestimation; customers are not defaulting as anticipated and management is adjusting the allowance account accordingly, or management is reducing the allowance account in order to decrease bad debt expense and increase net income in the current year.

Other information that would be useful to the analyst would be the valuation schedule required by the SEC and any notes or information in the management's discussion and analysis related to accounts receivable and bad debts.

4.	<u>2011</u>	<u>2010</u>
<u>Allowance for doubtful accts.</u>		
Accts. Receivable + Allow.	0.4%	1.7%
Growth rates: Sales	(2.5%)	

Accts. Receivable (net)	(59.0%)(A/R, gross, 59.5%)
Allowance for doubt. accts.	(90.8%)

Health Supplements, Inc. experienced a minimal decrease in sales in 2011; however, both the accounts receivable and allowance for doubtful accounts dropped significantly. The estimated percentage of bad debt relative to total accounts receivable has declined from 1.7% in 2010 to 0.4% in 2011, indicating management is expecting to collect nearly all of their accounts receivable in the future.

According to notes, Health Supplements, Inc. has three large customers that make up 75% of accounts receivable at the end of 2011. This is risky for the firm as a default by any one of those customers would be detrimental to the financial health of the firm. If Health Supplements, Inc. has performed high quality credit checks of the three largest customers and believe that there is little risk of default, then this could explain the decline in the allowance for doubtful accounts.

On the other hand, looking at the valuation schedule offers a different picture. In 2009 the allowance account was more than adequate for the minimal bad debts the firm actually wrote-off. In 2010 and 2011 actual write-offs increased each year by 408% and 156%, respectively. The current balance in the allowance account at the end of 2011 is \$20, while write-offs for that year totaled \$156. It is suspicious that the firm credited the bad debt expense account, which resulted in an increase to net income for 2011, when actual bad debts are rising significantly each year. It is possible that the firm intentionally understated the allowance account to make a poor earnings year look better.

5. a. The FIFO method assumes the first units purchased are the first units sold during an accounting period; therefore, the ending inventory would consist of the last units purchased during that accounting period.

b. The LIFO method assumes that the items purchased last are the first sold; therefore the ending inventory would consist of the first units purchased.

c. A manager may choose the FIFO method during a period of inflation in order to report higher earnings. Since the first units purchased would be included in cost of goods sold and they would be at lower relative prices, a higher earnings amount will result.

d. A manager may choose the LIFO method during a period of inflation in order to reduce taxes. Since the last units would be reported as cost of goods sold, they would reflect higher costs, thus reducing reported earnings. Lower earnings results in lower taxes and frees more cash for the firm.

6. During deflation costs of products are declining, therefore, the first goods purchased or produced would be valued at higher costs than those goods purchased or produced last. Firms using FIFO would have inventory values on the balance sheet at lower amounts compared to inventory valued using the LIFO method since the last goods purchased or produced would still be in inventory when using FIFO. On the income statement the cost of goods sold using FIFO would have the higher costs, relative to LIFO since the first goods are assumed to be sold first when using FIFO.

7. Total units available for sale	44
Units sold	<u>40</u>
Units in ending inventory	4

Cost of units purchased:

8 units x \$5 = \$40	
10 units x \$6 = \$60	
14 units x \$7 = \$98	
<u>12 units x \$6 = \$72</u>	
44 units	\$270 (average cost = \$6.14 per unit)

a. FIFO	Ending inventory = 4 units x \$6 = \$ 24
	Cost of goods sold expense = \$246
b. LIFO	Ending inventory = 4 units x \$5 = \$ 20
	Cost of goods sold expense = \$250
c. Average cost	Ending inventory = 4 units x \$6.14 = \$ 24.56
	Cost of goods sold expense = \$245.44

8. Total units available for sale	295
Units sold	<u>235</u>
Units in ending inventory	60

Cost of units purchased:

$$20 \text{ units} \times \$12 = \$ 240$$

100 units x \$11 = \$1,100

$$85 \text{ units} \times \$10 = \$ 850$$

$$\underline{90 \text{ units}} \times \$ 9 = \underline{\$ 810}$$

295 units \$3,000 (average cost = \$10.17 per unit)

a. FIFO Ending inventory = 60 units x \$9 = \$ 540

Cost of goods sold expense = \$2,460

b. LIFO Ending inventory = 20 units x \$12 = \$ 240

40 units x \$11 = \$ 440

\$ 680

Cost of goods sold expense = \$2,320

c. Average cost Ending inventory = 60 units x \$10.17 = \$ 610.20

Cost of goods sold expense = \$2,389.80

9. a. $\frac{\$20,000}{5 \text{ years}} = \$4,000 \text{ per year}$

Book value = \$20,000 - \$4,000 = \$16,000

b. $\$20,000 \times (2 \times .20) = \$8,000$

Book value = \$20,000 - \$8,000 = \$12,000

10. a. $\frac{\$500,000}{5 \text{ years}} = \$100,000 \text{ per year}$

b. $\$500,000 - 100,000 - 100,000 = \$300,000$

c. Deferred tax liability.

d. $\$120,000 - 100,000 = \$20,000$

11. $\$200,000 \times .10 \times 3/12 = \$5,000$

12.

	Tax	Reporting
Revenue	\$900,000	\$900,000
Expenses	<u>(650,000)</u>	<u>(580,000)</u>
Earnings before tax	\$250,000	\$320,000
Tax expense (× .35)	<u>(87,500)</u>	<u>(112,000)</u>
Net income	\$ 162,500	\$208,000

$$\text{Deferred tax liability} = \$112,000 - \$87,500 = \$24,500$$

13. A capital lease occurs when the lease is in substance a purchase rather than a lease. If a lease contract meets any one of four criteria—transfers ownership to the lessee, contains a bargain purchase option, has a lease term of 75% or more of the leased property's economic life, or has minimum lease payments with a present value of 90% or more of the property's fair value—the lease must be capitalized by the lessee according to the requirements of FASB. Leases not meeting one of the four criteria are treated as operating leases.

Operating leases require the lessee to record rent expense when payments are made on the lease. Even though there is a contractual obligation to make lease payments under an operating lease, since GAAP does not require the lessee to record a debt obligation on the balance sheet, the operating lease is referred to as off-balance-sheet financing.

Capital leases affect both the balance sheet and the income statement. An asset and a liability are recorded on the lessee's balance sheet equal to the present value of the lease payments to be made under the contract. The asset account reflects what is, in essence, the purchase of an asset; and the liability is the obligation incurred in financing the purchase. Each lease payment is apportioned partly to reduce the outstanding liability and partly to interest expense. The asset account is amortized with amortization expense recognized on the income statement, just as a purchased asset would be depreciated.

Disclosures about operating and capital leases can be found in the notes to the financial statements, often under both the property, plant, and equipment note and the commitments and contingencies note.

14. This account is meant to draw the attention to the user that required disclosures can be found in the notes to the financial statements. Commitments refer to contractual agreements which will have a significant impact on the firm in the future. Since the balance sheet does not report future information on the face,

the amounts of the future commitments are reported in the notes. Contingencies refer to potential liabilities of the firm. Generally the firm cannot reasonably predict the outcome and/or the amount of the future liability which is why no amount is reported on the balance sheet.

15. a. Total stockholders' equity = \$56,000 - \$32,000 = \$24,000

b. Dividends paid = \$9,800 + \$7,500 - \$10,400 = \$6,900

16. \$120,000 = \$72,000 + \$35,000 + Net income
Net income = \$13,000

17.

	Beginning retained earnings	+	net income	-	dividends	=	Ending retained earnings
2010	500	+	450	-	190	=	760
2011	760	+	325	-	210	=	875
2012	875	+	240	-	165	=	950

18. Firms often repurchase shares of their own stock for a variety of reasons that include meeting requirements for employee stock option and retirement plans, building shareholdings for potential merger needs, increasing earnings per share by reducing the number of shares outstanding in order to build investor confidence, preventing takeover attempts by reducing the number of shareholders, and as an investment use of excess cash holdings.

19. Current assets		Current liabilities	
Cash	25	Accounts payable	29
Short-term investments	22	Current portion of	
Accounts receivable	11	long-term debt	<u>5</u>
Inventory	13	Total current liabilities	34
Prepaid expenses	3	Long-term liabilities	
Deferred taxes, current	<u>6</u>	Long-term debt	<u>20</u>
Total current assets	80	Total liabilities	54
Long-term assets		Stockholders' equity	
Property & equipment	67	Common stock	1
		Add'l. paid-in capital	51

		Treasury stock	(4)
		Retained earnings	<u>45</u>
		Total stockholders' equity	<u>93</u>
Total assets	<u>147</u>	Total liabilities and equity	<u>147</u>

20.

<u>Assets</u>		<u>Liabilities and stockholders' equity</u>	
Current assets		Current liabilities	
Cash	3%	Accounts payable	18
Short-term investments	10	Current portion of	
Accounts receivable	13	long-term debt	<u>6</u>
Inventory	14	Total current liabilities	24%
Prepaid expenses	2	Long-term liabilities	
Deferred taxes, current	<u>4</u>	Long-term debt	<u>28</u>
Total current assets	46%	Total liabilities	52%
Long-term assets		Stockholders' equity	
Property & equipment	42	Common stock and PIC	32
Goodwill	8	Retained earnings	<u>16</u>
Long-term investments	3	-	
Other assets	<u>1</u>	Total stockholders' equity	<u>48%</u>
Total assets	<u>100%</u>	Total liabilities and equity	<u>100%</u>

21. By looking at the common size balance sheet, one can see that there have been structural changes in the components of the balance sheet equation. Cash and fixed assets have decreased, while accounts receivable, inventory and other assets have increased. The increase in the current assets could be a result of expansion; however, this is not supported when looking at the decline in property, plant and equipment. The company is using more debt, both current and long-term, which has caused a significant decline in the equity accounts. It is possible that the firm is operating at a loss given the large decline in retained earnings, although this may be just a result of the mathematical change in the debt accounts relative to equity accounts. The changes in the common size balance sheet warrant further investigation of the actual dollars on the financial statements and a thorough reading of the notes to the financial statement and the management discussion and analysis.

